CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

An Analysis of the President's Budgetary Proposals for Fiscal Year 1996

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Prepared at the Request of the Senate Committee on Appropriations

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NOTES

Unless otherwise indicated, all years referred to in Chapter 2 are calendar years, and all years in other chapters and Appendixes A and B are fiscal years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Numbers in the text and tables of this report may not add to totals because of rounding.

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Preface

This analysis of the President's budget for fiscal year 1996 was prepared at the request of the Senate Committee on Appropriations. The report discusses the President's policies in terms of changes from the Congressional Budget Office's (CBO's) baseline budget projections for 1996 through 2000. It provides estimates of the budgetary impact of the Administration's proposals using CBO's economic assumptions and technical estimating methods.

The report was prepared by the staffs of the Budget Analysis, Macroeconomic Analysis, and Tax Analysis divisions under the supervision of Paul Van de Water, Robert Dennis, and Rosemary D. Marcuss. James Horney wrote Chapters 1 and 3, John Peterson wrote Chapter 2, and Frank Sammartino wrote Chapter 4. Appendix A was written by Jeffrey Holland, and Appendix B was written by Robert Dennis. The baseline revenue estimates were prepared under the direction of Richard A. Kasten. The estimates of the President's revenue proposals were prepared by the Joint Committee on Taxation. The principal contributors to the revenue and spending estimates and analyses are listed in Appendix C.

Paul L. Houts supervised the editing and production of the report. Major portions were edited by Paul L. Houts, Sherwood D. Kohn, Leah Mazade, Sherry Snyder, and Chris Spoor. Chris Spoor also provided editorial assistance during production. The authors owe thanks to Marion Curry, Dorothy Kornegay, Linda Lewis, L. Rae Roy, and Simone Thomas, who assisted in the preparation of the report. Kathryn Quattrone prepared it for final publication.

June E. O'Neill
Director

April 1995

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Chapter One

Summary and Introduction

The Congressional Budget Office (CBO) estimates that under the policies proposed in the President's budget for fiscal year 1996, deficits would increase from $177 billion in 1995 to $276 billion in 2000. Except for the current year, the estimates of deficits under the President's policies based on CBO's economic and technical assumptions are higher than those stated in the President's budget. CBO estimates that the deficit in 2000 would be $82 billion higher than the Administration projects.

The President's policies would not substantially change the deficits from the levels that would result under current laws and policies. An exact estimate of the change, however, depends on what assumption is made about the level of discretionary spending under current policy after the statutory limits on discretionary spending expire at the end of 1998. (CBO assumes that baseline discretionary spending will equal the limits in 1996 through 1998.) Compared with CBO's baseline projections that assume discretionary spending in 1999 and 2000 will equal the 1998 limit adjusted for inflation, the President's policies would reduce the cumulative deficits in 1995 through 2000 by almost $30 billion. Compared with CBO's baseline projections that assume discretionary spending in 1999 and 2000 will be at the same level as in 1998, the President's policies would increase the deficits over the next six years by about $31 billion.

In addition to reestimating the President's budget, CBO has revised the baseline projections published in its January report *The Economic and Budget Outlook: Fiscal Years 1996-2000* to take account of new information. Those revisions slightly reduce the projected baseline deficit for 1995 but increase the deficits after that by amounts growing from $3 billion in 1996 to $15 billion in 2000 (see Appendix A).

CBO has also revised the illustrative path to a balanced budget published in the January report and expanded its analysis of the economic benefits of moving toward a balanced budget in 2002 (see Appendix B). That analysis includes estimates of the revenue increases and net interest savings that would result over the next seven years from the economic improvements.

CBO's Reestimate of the President's Budgetary Proposals

CBO estimates that under the President's policies the deficit would increase from $177 billion in 1995 to $276 billion in 2000, or from 2.5 percent of gross domestic product (GDP) to 3.1 percent (see Table 1). CBO estimates that total outlays under the President's policies would grow at an average annual rate of almost 5 percent over the next five years--from $1,532 billion in 1995 to $1,954 billion in 2000. Revenues would grow a little more slowly, about 4.4 percent a year on average, and would increase from $1,355 billion in 1995 to $1,678 billion in 2000.

CBO's estimates of the deficits for 1996 through 2000 under the President's policies are higher than those projected by the Administration, which anticipates that the deficit will be essentially the same in

Table 1.
CBO's Budgetary Estimates Under the President's Policies (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
Revenues	1,258	1,355	1,416	1,464	1,534	1,604	1,678
On-budget	923	998	1,041	1,072	1,122	1,173	1,226
Off-budget	335	357	375	392	411	431	452
Outlays	1,461	1,532	1,626	1,696	1,765	1,860	1,954
On-budget	1,182	1,244	1,324	1,383	1,439	1,517	1,598
Off-budget	279	289	303	313	326	342	356
Deficit	203	177	211	232	231	256	276
On-budget deficit	259	246	283	311	316	344	372
Off-budget surplus	56	69	72	79	85	89	96
Debt Held by the Public	3,432	3,622	3,851	4,109	4,372	4,658	4,965
Memorandum:							
Gross Domestic Product	6,632	7,036	7,370	7,747	8,152	8,572	9,013
	As a Percentage of GDP						
Revenues	19.0	19.3	19.2	18.9	18.8	18.7	18.6
On-budget	13.9	14.2	14.1	13.8	13.8	13.7	13.6
Off-budget	5.1	5.1	5.1	5.1	5.0	5.0	5.0
Outlays	22.0	21.8	22.1	21.9	21.7	21.7	21.7
On-budget	17.8	17.7	18.0	17.9	17.6	17.7	17.7
Off-budget	4.2	4.1	4.1	4.0	4.0	4.0	4.0
Deficit	3.1	2.5	2.9	3.0	2.8	3.0	3.1
On-budget deficit	3.9	3.5	3.8	4.0	3.9	4.0	4.1
Off-budget surplus	0.8	1.0	1.0	1.0	1.0	1.0	1.1
Debt Held by the Public	51.7	51.5	52.3	53.0	53.6	54.3	55.1

SOURCE: Congressional Budget Office.

2000 as in 1995 (see Table 2). For 1995, however, CBO expects that the deficit will be lower than anticipated by the Administration. Most of CBO's reestimate of the deficits reflects differences between its and the Administration's projections of the revenues and outlays that would occur under current laws and policies. CBO separates its reestimates of the Administration's budget into two categories: those that result from differences in economic assumptions and those that result from technical estimating differences. For 2000, economic and technical reestimates are almost equally responsible for the $82 billion difference between CBO's estimate of the deficit under the President's policies and the Administration's estimate.

Economic Reestimates

The economic assumptions of CBO and the Administration appear quite similar. Yet the differences are sufficient to produce noticeable differences in budget projections. CBO's economic assumptions lower the projected deficits for 1995 and 1996 compared with the Administration's assumptions but raise the deficits thereafter. Although it assumes lower growth for the current year, the Administration foresees faster economic growth on average between now and 2000. It projects roughly the same rate of inflation as CBO and a marginally lower rate of unemployment after 1997.

In addition, the Administration forecasts somewhat higher interest rates than does CBO. The Administration and CBO (as well as the consensus of private-sector economists reflected in the *Blue Chip* survey) assume that the tightening of monetary policy over the past year will cause economic growth to slow from its pace of 1994. The forecasts differ somewhat, however, in the timing and degree of the slowdown. CBO (and the *Blue Chip* survey) anticipate significantly faster growth this year than next. The Administration assumes a smoother path with real (inflation-adjusted) growth of about 2½ percent in both 1995 and 1996.

Differences between CBO's economic forecast and that of the Administration push down CBO's projected revenues by more than $40 billion in 2000 compared with the Administration's estimates. CBO's lower projections of corporate profits reduce revenues in every year compared with the Administration's projections. CBO also projects lower imports than does the Administration, and the resulting lower estimate of customs duties holds CBO's estimate of other revenues below the Administration's in every year but 1995. CBO projects higher individual income than the Administration does through 1998 but lower income in 1999 and 2000. In 1995 and 1996, the higher individual income tax and social insurance receipts resulting from CBO's forecast for individual income more than offset the revenue effects of the other aspects of CBO's economic forecast. From 1997 on, however, CBO's economic forecast reduces revenues compared with the Administration's forecast.

CBO's economic assumptions also reduce its projection of spending compared with that of the Administration but by far less than the reduction in revenues. CBO's lower unemployment forecast pushes down its estimate of unemployment benefit payments by $1 billion in 1995 and 1996. But after that, less than $500 million of the difference between CBO's and the Administration's projections of unemployment costs in any year is the result of differences in economic assumptions. Because it projects a more rapid increase in the consumer price index, CBO estimates that the costs of other benefit programs (Social Security and other programs with automatic cost-of-living adjustments) will be higher. CBO's projection of interest payments is below the Administration's, since CBO assumes lower interest rates.

Technical Reestimates

Estimating differences unrelated to economic assumptions add to CBO's estimates of the deficits under the President's budgetary policies compared with the Administration's estimates over the 1996-2000 period. Excluding economic differences, CBO's projection of revenues in 2000 is about $8 billion higher than the Administration's, but CBO's projection of spending is $50 billion higher. Nearly half of the difference in projected spending can be found in the Medicare and Medicaid programs. Although CBO believes that the growth of those programs has

Table 2.
CBO's Reestimates of the President's Budgetary Proposals (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Deficit Under the President's Budgetary Proposals as Estimated by the Administration	193	197	213	196	197	194
Economic Reestimates						
Revenues[a]						
Individual income and social insurance taxes	-15	-13	-9	-4	4	7
Corporate profits taxes	3	8	13	14	17	22
Other	b	1	4	7	9	11
Subtotal	-13	-4	8	17	29	41
Outlays						
Unemployment compensation	-1	-1	b	b	b	b
Other benefit programs	b	b	1	2	3	5
Net interest	b	1	-3	-7	-7	-6
Other	b	b	b	b	b	b
Subtotal	-1	b	-2	-5	-4	-1
Total, economic reestimates	-13	-4	5	12	25	40
Technical Reestimates						
Revenues[a]						
Individual income and social insurance taxes	b	3	1	-1	-6	-7
Corporate profits taxes	-1	-2	-2	-3	-5	-5
Other	4	2	2	2	3	4
Subtotal	4	4	b	-2	-8	-8
Outlays						
Medicaid	1	3	5	7	10	12
Medicare	4	4	6	7	9	11
FCC spectrum auctions	-5	3	1	2	b	-1
Unemployment compensation	1	1	1	2	2	3
Housing assistance	b	1	2	5	9	10
Deposit insurance	-3	-1	-3	-6	-2	1
Net interest	1	2	4	5	6	8
Other	-3	1	-3	3	7	7
Subtotal	-6	15	14	25	41	50
Total, technical reestimates	-2	18	14	23	33	42
Total Reestimates	-16	14	19	35	58	82
Deficit Under the President's Budgetary Proposals as Estimated by CBO	177	211	232	231	256	276

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: FCC = Federal Communications Commission.

a. Revenue reductions are shown as positive because they increase the deficit.

b. Less than $500 million.

slowed from the extremely high rates of recent years, it is not quite as optimistic as the Administration about the slowdown. Given the size of those two programs and the uncertainty about their future costs, the projections of CBO and the Administration are not very far apart.

CBO and the Administration differ in their assumptions about the timing of proceeds from auctioning portions of the electromagnetic spectrum by the Federal Communications Commission. In estimating spending for unemployment compensation, CBO assumes that average benefits will be higher than the Administration projects. CBO's reestimate of net outlays by deposit insurance agencies reflects both its more optimistic outlook about future failures of banks and thrift institutions and its higher estimate of proceeds from the sale of assets acquired by the government as a result of previous thrift failures. Another difference between CBO and the Administration is in the estimates of discretionary spending for housing assistance programs. However, the Department of Housing and Urban Development is in the process of revising and updating the Administration's assisted housing proposals, which may significantly reduce the difference between CBO's and the Administration's estimates in this area. The difference in projected net interest costs primarily reflects the debt service on the increase in the projected deficits that result from other technical reestimates.

CBO's Estimate of the Effects of the President's Budgetary Proposals

CBO estimates that enacting the President's budgetary proposals would not significantly change the deficits from the levels it projects under current laws and policies (see Table 3). The President's proposed changes in nondiscretionary spending and revenues would increase the deficit by almost $40 billion over the 1995-2000 period, but the discretionary appropriations proposed in the budget are below CBO's projections of discretionary spending under current policies. How much of a reduction the discretionary proposals represent--as well as CBO's estimate of the net effect on the deficits of all of the President's policies--depends on assumptions about discretionary spending in 1999 and 2000.

The President has proposed tax measures that would shrink revenues by almost $60 billion over the 1995-2000 period and by $20 billion in 2000. Proposed savings in Medicare (stemming primarily from extending provisions of the Omnibus Budget Reconciliation Act of 1993 that expire at the end of 1998) and other mandatory programs offset only about $17 billion of the revenue loss over the six-year period and $8 billion of the loss in 2000. The President has also proposed to sell assets that CBO estimates would produce almost $8 billion in income. Other proposals would increase nondiscretionary spending (other than net interest) by almost $4 billion.

Assessing the change in the deficit that can be attributed to the President's discretionary spending proposals is not so straightforward because proposed discretionary spending can be measured against two different baselines. The two baselines are the same through 1998: both include CBO's estimate of discretionary spending in 1995 from already enacted appropriations, and both assume that discretionary spending for 1996 through 1998 will equal the statutory limits on such spending contained in the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act). After 1998--the last year that the statutory limits are in effect--one baseline assumes that discretionary spending equals the 1998 limit adjusted for inflation. The other assumes that there is no adjustment for inflation after 1998--in other words, that discretionary spending in 1999 and 2000 will be the same in nominal terms as in 1998.

According to CBO's estimates, the President's proposals would result in discretionary spending that ranges from $550 billion in 1995 to $561 billion in 2000. Compared with CBO's baseline with discretionary inflation after 1998, the President's proposals would reduce discretionary spending by $67 billion in 1995 through 2000, with most of the reductions in the last two years. Those savings more than offset the deficit increases that result from the President's revenue and mandatory spending proposals and produce net deficit reduction of almost $30 billion in the 1995-2000 period. Compared with CBO's baseline without discretionary inflation, the President's pro-

Table 3.
CBO's Estimates of the President's Budgetary Proposals (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Changes from CBO's Baseline With Discretionary Inflation After 1998						
CBO's Baseline Deficit With Discretionary Inflation After 1998[a]	175	210	230	232	266	299
President's Budgetary Proposals						
Pay-as-you-go						
Revenues[b]	c	2	11	13	15	20
Outlays	0	c	-1	-2	-5	-8
Subtotal	c	2	10	11	9	11
Asset sales[d]	0	-1	-4	-3	0	0
Discretionary appropriations	2	-1	-5	-9	-21	-34
Other outlays	c	c	c	1	1	1
Debt service	c	c	c	c	c	-2
Total Changes	2	1	2	-1	-11	-23
Deficit Under the President's Budgetary Proposals as Estimated by CBO	177	211	232	231	256	276
Changes from CBO's Baseline Without Discretionary Inflation After 1998						
CBO's Baseline Deficit Without Discretionary Inflation After 1998[e]	175	210	230	232	247	258
President's Budgetary Proposals						
Pay-as-you-go						
Revenues[b]	c	2	11	13	15	20
Outlays	0	c	-1	-2	-5	-8
Subtotal	c	2	10	11	9	11
Asset sales[d]	0	-1	-4	-3	0	0
Discretionary appropriations	2	-1	-5	-9	-2	4
Other outlays	c	c	c	1	1	1
Debt service	c	c	c	c	1	2
Total Changes	2	1	2	-1	9	18
Deficit Under the President's Budgetary Proposals as Estimated by CBO	177	211	232	231	256	276

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

a. Projections assume discretionary spending is equal to the spending limits that are in effect through 1998 and is equal to the 1998 limit adjusted for inflation after that.

b. Revenue reductions are shown as positive because they increase the deficit.

c. Less than $500 million.

d. Under current law, proceeds from asset sales are not counted for purposes of the Congressional Budget Act or the Balanced Budget and Emergency Deficit Control Act enforcement procedures. The President has proposed that the proceeds from the sales in his budget should be counted for those purposes.

e. Projections assume discretionary spending is equal to the spending limits that are in effect through 1998 and is equal to the 1998 limit after that.

posals would reduce discretionary spending over those six years by only about $10 billion. Because those cuts are not enough to offset the increases in the deficit resulting from other proposals, the deficits under the President's policies represent an increase of about $31 billion in 1995 through 2000 compared with the deficits projected in this baseline.

CBO estimates that the President's mandatory spending and revenue proposals would add more than $22 billion in deficit increases to the pay-as-you-go scorecard in 1995 through 1998 (the pay-as-you-go procedures of the Balanced Budget Act are scheduled to expire after 1998). The President has recommended disposing of assets that CBO estimates would sell for nearly $8 billion. Under current law, those proceeds would not count for pay-as-you-go purposes, but the President has proposed that the law be changed to allow the asset sales to be counted.

In addition, the Administration asserts that a proposed reduction in the discretionary spending limits (to the levels of discretionary spending in the President's budget) should be counted as pay-as-you-go savings. Based on CBO's estimates, total nonemergency discretionary spending proposed by the President is $20 billion below the current limits for 1996 through 1998. CBO believes, however, that the current budget enforcement process reflects a clear decision by lawmakers that discretionary spending should be subject to different budgetary control mechanisms than would be applied to mandatory spending and receipts. Therefore, in CBO's view, reductions in the discretionary spending limits cannot be included in the pay-as-you-go scorecard without a change in law.

Most of the supposed savings in discretionary spending result from an increase in the discretionary appropriation limits made by the Office of Management and Budget (OMB) in the sequestration preview report included in the President's budget. OMB interpreted a provision of the Omnibus Budget Reconciliation Act of 1993 as allowing a new method of calculating the required adjustment to the limits for changes in inflation. Instead of continuing to adjust the limits for the difference between actual inflation experienced in the most recently completed fiscal year (1994 in this instance) and the inflation anticipated for that year when the limits were set, OMB adjusted for the differences between its current forecast of inflation for 1996, 1997, and 1998 and the inflation forecast for those years when the limits were set.

CBO estimates that the change in method increased the limits by almost $16 billion in 1996 through 1998. Although CBO believes that OMB's interpretation of the law is incorrect, CBO will continue to use OMB's limits in its baseline budget projections. Therefore, CBO's estimates of the President's budget show savings in discretionary spending compared with OMB's official estimate of the limits through 1998. CBO's estimated savings in discretionary spending after 1998 also reflect the higher OMB limits because CBO's baseline projections of discretionary spending in those years take the 1998 limit as their starting point. If CBO had not adjusted its baseline estimates of discretionary spending to conform to OMB's official limits, CBO's estimate of discretionary savings proposed in the President's budget would have been significantly smaller. Moreover, CBO's estimate of the overall effect of the President's policies would have shown an increase in total deficits over the 1995-2000 period, even when compared with CBO's baseline that includes discretionary inflation after 1998.

Chapter Two

Comparison of Economic Forecasts

The economic assumptions of the Clinton Administration and the Congressional Budget Office are similar. The differences, however, are sufficient to raise the Administration's projections of the deficit for 1995 and 1996 slightly above CBO's and to lower them for 1997 through 2000. The Administration foresees slower growth for 1995 but faster growth on average between 1996 and 2000. It also projects roughly the same rate of inflation overall, a marginally lower rate of unemployment, and higher interest rates. In addition, the Administration's forecast for the share of gross domestic product subject to taxation is slightly lower than CBO's for the near term but is higher for 1997 through 2000.

The Administration's economic assumptions incorporate the effects of its 1996 budget proposal, whereas CBO's forecast and projections are based on current law. The Administration's budget does not differ greatly from current law, however, as far as its effect on the overall economy is concerned, so the difference in assumptions about fiscal policy is not a cause of differences in the economic assumptions.

The Short-Term Outlook, 1995-1996

The differences between the Administration's and CBO's forecasts do not affect the short-term deficit outlook significantly. The Administration assumes, as do CBO and economists generally, that the economy is at a high rate of resource use and that inflationary pressures are building. Furthermore, CBO, the Administration, and a consensus of private-sector economists reflected in the *Blue Chip Economic Indicators* all expect that the tightening of monetary policy over the past year will ultimately cause the economy to cool. The three forecasts differ, however, in the timing and degree of the slowdown. CBO and the *Blue Chip* anticipate about 3 percent growth in 1995 and significant slowing next year, although CBO is more pessimistic than the *Blue Chip* for 1996. In contrast, the Administration assumes less growth this year and little further slowing in 1996 (see Table 4).

Other differences among the three short-term forecasts are also slight. The *Blue Chip* foresees higher inflation in 1996 than do the other two and, consequently, higher interest rates as well. The Administration's forecast for inflation and interest rates is similar to CBO's.

The Outlook for the Projection Period, 1997-2000

The Administration expects faster growth on average, a different pattern of price change, and higher interest rates than does CBO for 1997 through 2000. The average growth of real GDP is 0.2 percentage points per year greater than CBO's. Both the Administration and CBO assume an average unemployment rate of just below 6 percent for the period. The implicit GDP deflator grows faster in the Administration's outlook than in CBO's by about 0.2 percentage points, but CBO's projections for inflation as measured by the consumer price index (CPI) are higher

by about 0.2 percentage points. Finally, the Administration projects higher nominal interest rates.

The Administration is generally closer than CBO to the *Blue Chip's* long-range projections. The *Blue Chip* indicates the same average growth over the 1997-2000 period as the Administration and has similar projections for interest rates and the GDP deflator. Only in its projections for the CPI is the *Blue Chip* significantly closer to CBO's projection than to the Administration's.

Real Growth

Real growth over the 1997-2000 period averages 2.5 percent in the Administration's projection, compared with 2.3 percent in CBO's. A useful way to compare

Table 4.
Comparison of Congressional Budget Office, Administration, and *Blue Chip* Economic Projections, Calendar Years 1994-2000

	Actual	Forecast		Projected			
	1994	1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)							
CBO	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Administration	6,735	7,117	7,507	7,921	8,361	8,832	9,310
Real GDP[a] (Percentage change, year over year)							
CBO	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Administration	4.0	2.8	2.5	2.5	2.5	2.5	2.5
Blue Chip	4.0	3.2	2.2	2.0	2.3	2.9	2.8
GDP Deflator (Percentage change)							
CBO	2.1	2.6	2.8	2.8	2.8	2.8	2.8
Administration	2.1	2.8	3.0	3.0	3.0	3.0	3.0
Blue Chip	2.1	2.6	3.2	3.3	3.1	3.0	3.0
Consumer Price Index[b] (Percentage change, year over year)							
CBO	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Administration	2.6	3.1	3.2	3.2	3.2	3.1	3.1
Blue Chip	2.6	3.2	3.6	3.4	3.4	3.4	3.4
Civilian Unemployment Rate (Percent)							
CBO	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Administration	6.1	5.8	5.9	5.8	5.8	5.8	5.8
Blue Chip	6.1	5.5	5.7	6.0	6.2	6.0	5.8

(Continued)

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1995).

NOTE: GDP = gross domestic product.

projections is to look at the growth of nonfarm business GDP, which excludes the output of farms, government workers, and housing services. That measure of output, which is projected to grow slightly faster than total GDP, can be broken down into two categories: the growth in total hours worked and the growth in labor productivity. The Administration's projection of nonfarm business GDP is slightly greater than CBO's because the Administration has a slightly more optimistic view of both the future growth in hours worked (1.4 percent a year compared with CBO's 1.3 percent) and the growth in labor productivity (also 1.4 percent versus 1.3 percent).

Given the large changes in the growth of hours worked and labor productivity since the late 1950s, the differences between the Administration's and CBO's projections are small. Hours worked rose at

Table 4.
Continued

	Actual	Forecast		Projected			
	1994	1995	1996	1997	1998	1999	2000
Three-Month Treasury Bill Rate (Percent)[c]							
CBO	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Administration	4.2	5.9	5.5	5.5	5.5	5.5	5.5
Blue Chip	4.2	6.1	6.1	5.5	5.3	5.2	5.4
Ten-Year Treasury Note Rate (Percent)							
CBO	7.1	7.7	7.0	6.7	6.7	6.7	6.7
Administration	7.1	7.9	7.2	7.0	7.0	7.0	7.0
Blue Chip[d]	7.1	7.6	7.4	7.2	7.1	7.0	7.2
Nominal Income (Percentage of GDP)							
Wage and salary disbursements							
CBO	48.7	48.8	48.9	48.8	48.7	48.6	48.5
Administration	48.7	48.2	48.1	48.0	47.9	47.8	47.7
Other personal income[e]							
CBO	36.0	36.4	36.9	37.2	37.6	38.0	38.4
Administration	36.0	36.4	36.7	37.0	37.4	37.7	38.0
Corporate profits[f]							
CBO	7.8	7.5	7.2	7.1	7.0	6.9	6.8
Administration	7.8	7.6	7.6	7.6	7.5	7.5	7.7

a. Based on 1987 dollars.

b. Consumer price index for all urban consumers (CPI-U).

c. The *Blue Chip* projects the secondary market rate for three-month Treasury bills; CBO and the Administration project the auction average rate.

d. The *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

e. Personal income less wage and salary disbursements.

f. Corporate profits reported are book, not economic, profits.

an annual rate of 2.3 percent between 1959 and 1969, 1.9 percent between 1969 and 1979, and 1.7 percent between 1979 and 1988. The decline continued in the 1988-1994 period--hours worked rose just 1.1 percent. The slowing of growth since the mid-1970s stems largely from the smaller increase in the size of the working-age population (down from 2.1 percent a year during the 1970s to about 1.0 percent in recent years). Growth in hours worked also eased because of a slowdown in the growth of labor force participation rates (that is, the percentage of the working-age population that is working or seeking work). The causes of that slowdown, particularly in recent years, are not well understood, raising the level of uncertainty about projections of growth in hours worked. Many forecasters anticipate a gentle rebound in participation rates during the last half of the 1990s that will result in a slight increase in the growth of hours worked. CBO's assumption that hours worked will rise to 1.3 percent and the Administration's assumption of 1.4 percent are both close to the consensus opinion.

The growth of labor productivity has also fallen--from 2.4 percent during the 1960s, to 1.3 percent during the 1970s, to 1.0 percent between 1979 and 1987. Growth between 1987 and 1994 is currently reported as 1.2 percent, although recent data on labor productivity are subject to revision. Both the Administration and CBO anticipate a slight pickup in productivity growth, largely because of the high rates of investment in recent years. With the rapid growth in the available stock of equipment and technology, the productivity of labor is likely to accelerate moderately. As with growth in hours worked, projections of increases in productivity are subject to great uncertainty. Given that uncertainty, the differences between CBO's and the Administration's assumptions are not large.

Inflation

The Administration projects somewhat lower inflation than CBO, as measured by the growth of the consumer price index, although the difference is only 0.2 or 0.3 percentage points. Such a small difference in inflation would not normally create any significant difference in projections of the deficit, since it would affect items on the revenue and outlay sides of the budget in a roughly offsetting way.

The comparison is clouded, however, because CBO and the Administration differ in their projections of the growth of the CPI, which affects indexed programs and tax brackets, relative to that of the GDP deflator, which affects estimates of taxable income. CBO assumes that the CPI will grow significantly faster than the deflator from 1997 through 2000, whereas the Administration assumes only slightly faster growth. Projections of federal outlays are heavily affected by changes in the CPI because it is the index for programs such as Social Security, Supplemental Security Income, and Military and Civil Service Retirement. Projections of federal revenues, however, are affected by changes in the deflator, since the growth in taxable income overall is closely related to the growth in nominal GDP. The Administration's projections indicate that the CPI will grow only about 0.2 percentage points faster than the deflator, whereas CBO anticipates a difference of 0.6 percentage points.

The historical evidence implies that the difference in the growth rates of the CPI and the GDP deflator will be larger than that projected by the Administration. Between 1987 and 1994, the CPI increased an average of 0.5 percentage points a year faster than the GDP deflator. The two measures of price changes differ over the long run primarily because of the way computer prices affect them. Computers constitute a much bigger share of GDP than of the basket of goods used to calculate the CPI, and the continued decline in their prices will dampen the growth of the GDP measure of price far more than that of the CPI. Furthermore, computer expenditures are projected to grow as a share of GDP. The weight of computers in the GDP deflator increases with their share of GDP, whereas the weight of computers in the CPI will continue to be small.

Although computers are the primary cause of the difference in the growth rates of inflation, the measures differ for other reasons as well. One major offset to the effect of computer prices on the relative growth of the CPI and the deflator is medical care. The price of medical care, which is weighted more heavily in the deflator than in the CPI, has risen

faster than the CPI on average over the past 10 years, a trend that is expected to continue. Other sectors, however, reinforce the effect that computers have on the spread between the growth of the CPI and the deflator. Prices of business equipment excluding computers and residential and business structures, which are not included in the CPI, have been increasing much more slowly than the CPI. On balance, the recent trends in those sectors also indicate that the CPI will grow about 0.6 percentage points faster than the GDP deflator over the next several years.

Several revisions in the CPI that the Bureau of Labor Statistics has recently completed or intends to carry out in the next few years would probably slow the growth of that measure. Most of those revisions, however, would also apply to the GDP deflator and thus would not significantly affect the difference between the indexes. In 1998, the Bureau of Labor Statistics will update the weights in the CPI, and that will probably slow the growth of the CPI relative to that of the GDP deflator. But the slowing is unlikely to be large enough to offset the other factors, such as the decline in computer prices, that drive a wedge between those indexes.

Interest Rates

The projections of CBO and the Administration differ only a little on interest rates in the short term, but more noticeable differences emerge in later years. After 1996, both short-term and long-term nominal interest rates are higher in the Administration's projections than in CBO's. Judged against the projections of the CPI, the Administration's rates are also significantly higher than CBO's. Using CBO's projections of inflation-adjusted interest rates rather than the Administration's would reduce projected deficits for the 1997-2000 period.

The Administration projects that the inflation-adjusted interest rate on three-month Treasury bills will average about 2.3 percent after 1996, compared with 1.7 percent for CBO. The *Blue Chip's* long-range projection of 2.0 percent lies between those two forecasts. All three sets of projections of real short-term interest rates are substantially higher than the rates that prevailed during the most recent recession and the early years of the expansion. The projected rates reflect the small amount of capacity currently available for further economic expansion; they fall within the range of the real rates that prevailed in the late 1980s. The Administration's projections of real long-term rates are higher than CBO's by about the same margin as the short-term rates (roughly 0.6 percentage points).

Share of National Income Subject to Taxation

Estimates of future deficits are affected by the projected distribution of total gross domestic product among various income categories, as well as by the overall size of GDP. Some of those categories--such as corporate profits, wages and salaries, and dividends--are taxable income. A projection that assumes a larger share of GDP for income categories that are taxed at relatively high rates would generate a larger revenue estimate than a projection that assumed a smaller share for such categories. Corporate profits and wages and salaries are taxed at the highest effective marginal rates. (The effective marginal tax rate on a given component of income represents the amount of additional tax collected from each additional dollar of income.) Dividends and interest are taxed at a lower effective rate because they are not subject to payroll taxes and some of them are received by tax-exempt entities. Compliance problems reduce the effective tax rate on the income of proprietors.

The Administration's projections of these various income shares reduces estimates of future deficits in the longer term but result in forecasts of deficits for 1995 and 1996 that are higher than CBO's. The Administration's projection of the wage and salary share of GDP is lower than CBO's throughout the 1995-2000 period and the corporate profits share is higher (see Table 4). The Administration's projections of these income shares, together with its projections of the shares of other categories of taxable income (not shown separately in Table 4), result in lower revenues over the next two years in comparison with CBO's projections but higher revenues thereafter.

The Administration's assumption of the share of total taxable income for 2000 is close to the average of the past 20 years, whereas CBO assumes the taxable share will gradually fall. The decline in the CBO projection stems in part from the assumed increase in the share of labor compensation that is not subject to tax, specifically medical care benefits (the employer's share of medical care insurance premiums is a significant part of the compensation to workers, but it is not taxable income). CBO also assumes that dividend income will account for a smaller share of gross domestic product in 2000 than it has recently. This projection is tied to that of the corporate profit share, which has been abnormally high for over two years and is likely to decline over the projection period.

Chapter Three

The Administration's Spending Proposals

The Congressional Budget Office estimates that total federal spending under the policies proposed in the President's budget would grow from $1,532 billion in 1995 to $1,954 billion in 2000 (see Table 5). As a percentage of gross domestic product, total annual spending would hardly change at all. It would hover just under 22 percent of GDP throughout the 1995-2000 period. The President's proposals for discretionary spending are responsible for the restrained growth in total spending. Total nondiscretionary outlays other than net interest would grow from 10.6 percent of GDP in 1995 to 12 percent in 2000, and spending for net interest would increase slightly as a percentage of GDP over that period. Under the President's policies, however, total discretionary spending would increase by only $11 billion from 1995 to 2000 and shrink from 7.8 percent of GDP in 1995 to 6.2 percent in 2000.

Mandatory Spending

The President's policies would have little effect on the growth of mandatory spending. CBO projects that total nondiscretionary spending (excluding net interest) under current laws and policies will grow at an average annual rate of almost 8 percent over the 1995-2000 period--from $747 billion in 1995 to $1,088 billion in 2000. Under the President's policies, the growth would be only slightly slower, and outlays in 2000 would be only about $7 billion lower than CBO's baseline projections.

CBO estimates that savings from mandatory spending policies proposed by the President that would be recorded on the pay-as-you-go scorecard under the Balanced Budget Act total $8 billion in 2000 and almost $17 billion over the 1996-2000 period (see Table 6). The Administration assumes the savings from those policies would be almost $3 billion higher over the five years. (Because the pay-as-you-go procedures are scheduled to expire at the end of 1998, only the savings for 1996 through 1998--which total about $3.5 billion--would actually be recorded on the scorecard under current law.) Savings in the Medicare program account for more than $6 billion of the savings in 2000 and $11 billion of the five-year total. Those savings are achieved by extending provisions of law enacted in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) that are scheduled to expire at the end of 1998. Almost $4 billion of the savings in 2000 comes from extending the requirement that Medicare Part B premiums paid by beneficiaries cover 25 percent of the total costs of Part B.

Extending provisions of OBRA-93 that are scheduled to expire in 1998 also accounts for almost all of the proposed $2.5 billion reduction in spending for veterans' programs in 1996 through 2000. About half of the $1 billion in savings in 2000 comes from extending the limit on pensions paid to veterans receiving nursing home care paid for by Medicaid (about half of those savings are offset by higher Medicaid costs). Extending current authority to collect payments from commercial insurers for medical services provided by the Department of Veterans Affairs to privately insured individuals produces an additional quarter of the total reduction in spending in 2000.

Proposed limitations on the earned income tax credit would reduce spending for the refundable por-

Table 5.
CBO's Estimates of the President's Spending Proposals (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
	Outlays in billions of dollars						
Discretionary							
Defense	282	271	264	258	255	260	268
International	21	22	21	21	20	20	19
Domestic	243	257	266	269	272	275	273
Subtotal	546	550	551	548	548	555	561
Mandatory	791	843	897	961	1,025	1,096	1,174
Deposit Insurance	-8	-16	-8	-4	-5	-3	-2
Net Interest	203	235	261	271	281	296	312
Offsetting Receipts	-71	-80	-74	-76	-80	-84	-91
Asset Sales	0	0	-1	-4	-3	0	0
Total	1,461	1,532	1,626	1,696	1,765	1,860	1,954
On-budget	1,182	1,244	1,324	1,383	1,439	1,517	1,598
Off-budget	279	289	303	313	326	342	356
Memorandum:							
Gross Domestic Product	6,632	7,036	7,370	7,747	8,152	8,572	9,013
	Outlays as a Percentage of GDP						
Discretionary							
Defense	4.3	3.9	3.6	3.3	3.1	3.0	3.0
International	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Domestic	3.7	3.6	3.6	3.5	3.3	3.2	3.0
Subtotal	8.2	7.8	7.5	7.1	6.7	6.5	6.2
Mandatory	11.9	12.0	12.2	12.4	12.6	12.8	13.0
Deposit Insurance	-0.1	-0.2	-0.1	-0.1	-0.1	a	a
Net Interest	3.1	3.3	3.5	3.5	3.4	3.4	3.5
Offsetting Receipts	-1.1	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Asset Sales	0	0	a	a	a	0	0
Total	22.0	21.8	22.1	21.9	21.7	21.7	21.7
On-budget	17.8	17.7	18.0	17.9	17.6	17.7	17.7
Off-budget	4.2	4.1	4.1	4.0	4.0	4.0	4.0

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.

tion of the credit (which is counted as outlays) by $2 billion in 1996 through 2000. (The proposals would also increase revenues by more than $300 million over that period.) The proposals would deny the credit to families with more than $2,500 in interest and dividend income during a year and would tighten compliance procedures to ensure that illegal and nonresident aliens did not receive the credit.

More than $3 billion in savings in 1996 through 2000 is attributed to the President's proposals to speed up and complete the shift in the student loan

Table 6.
Estimates of the President's Pay-As-You-Go Spending Proposals (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Medicare						
Administration estimate	0	-0.1	-0.5	-0.7	-3.1	-5.4
CBO estimate	0	-0.1	-0.5	-0.7	-3.4	-6.2
CBO minus Administration	0	a	a	-0.1	-0.3	-0.8
Accelerate Shift to Direct Student Loans						
Administration estimate	0	-0.3	-0.7	-1.0	-0.9	-1.1
CBO estimate	0	-0.2	-0.7	-0.9	-0.7	-0.7
CBO minus Administration	0	0.1	a	0.1	0.3	0.4
Earned Income Tax Credit						
Administration estimate	0	a	-0.6	-0.6	-0.6	-0.7
CBO estimate	0	a	-0.5	-0.5	-0.5	-0.5
CBO minus Administration	0	a	0.1	0.1	0.1	0.1
Veterans' Programs						
Administration estimate	0	-0.1	-0.1	-0.2	-1.3	-1.4
CBO estimate	0	-0.1	-0.1	-0.1	-1.0	-1.1
CBO minus Administration	0	a	a	0.1	0.3	0.3
Other						
Administration estimate	0	0.4	0.2	-0.4	-0.1	-0.1
CBO estimate	0	0.1	0.4	0.4	0.5	0.3
CBO minus Administration	0	-0.3	0.2	0.8	0.6	0.4
Total						
Administration estimate	0	-0.2	-1.7	-2.8	-6.1	-8.7
CBO estimate	0	-0.3	-1.3	-1.8	-5.1	-8.2
CBO minus Administration	0	-0.1	0.4	1.0	1.0	0.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: This table includes only those proposals that CBO would count for purposes of the pay-as-you-go procedures of the Balanced Budget and Emergency Deficit Control Act of 1985. The President's budget included proceeds from proposed asset sales in its calculation of pay-as-you-go effects. Under current law, proceeds from asset sales are not counted for purposes of the pay-as-you-go enforcement procedures. The President has proposed that the proceeds from the sales in his budget should be counted for those purposes. The President's budget also assumes that reductions in the statutory limits on discretionary spending can be counted as pay-as-you-go savings. CBO believes that changes in the discretionary limits cannot be counted under current law.

a. Less than $50 million.

program from the government guaranteeing loans made to students by private lenders to the government making the loans directly to the students. Under current law, direct student loans are required to account for 60 percent of the total loan volume in 1998 and subsequent years. Under the President's proposals, direct loans would fully replace guaranteed loans by 1998. Most of the estimated savings resulting from the shift from guaranteed to direct loans stems from the different treatment of administrative costs in the projections of the loan subsidy costs of the two programs. Under the Credit Reform Act of 1990, administrative costs that are paid directly by the federal government (as are most of the costs associated with direct loan programs) are not included in the estimated subsidy cost of a loan. However, administrative costs that are paid by another entity (as are most of the costs associated with guaranteed loans) are implicitly included in the calculation of the subsidy costs. Therefore, in any esti

Table 7.
Estimates of the President's Asset Sale Proposals (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Naval Petroleum Reserve Elk Hills Crude Oil						
Administration estimate	0	-0.1	-2.6	0	0	0
CBO estimate	0	-0.1	-1.5	0	0	0
CBO minus Administration	0	0	1.1	0	0	0
Federal Housing Administration Nonperforming Notes						
Administration estimate	0	-0.2	0	0	0	0
CBO estimate	0	0	0	0	0	0
CBO minus Administration	0	0.2	0	0	0	0
U.S. Enrichment Corporation						
Administration estimate	0	-0.8	-1.1	0	0	0
CBO estimate	0	-0.5	-1.1	0	0	0
CBO minus Administration	0	0.3	0	0	0	0
Power Marketing Administrations						
Administration estimate	0	-0.1	-0.9	-3.5	0	0
CBO estimate	0	-0.1	-0.9	-3.5	0	0
CBO minus Administration	0	0	0	0	0	0
Total						
Administration estimate	0	-1.2	-4.6	-3.5	0	0
CBO estimate	0	-0.7	-3.5	-3.5	0	0
CBO minus Administration	0	0.5	1.1	0	0	0

SOURCE: Congressional Budget Office.

NOTE: The President's budget included proceeds from proposed asset sales in its calculation of pay-as-you-go effects. Under current law, proceeds from asset sales are not counted for purposes of the pay-as-you-go enforcement procedures. The President has proposed that the proceeds from the sales in his budget should be counted for those purposes.

mate of savings from shifting from guaranteed loans to direct loans, at least some administrative costs will drop out of the calculation of the subsidies.

The President's proposals also include some changes in mandatory spending that would not appear on the pay-as-you-go scorecard. For instance, the President has proposed selling naval petroleum reserves, three power marketing administrations, and the United States Enrichment Corporation (along with the highly enriched uranium owned by the corporation). CBO estimates that proceeds from those proposed sales would total almost $8 billion in 1996 through 1998 (see Table 7). However, under current law, those proceeds are not counted as deficit reduction for purposes of the pay-as-you-go procedures. The President has proposed changing the law to allow those proceeds to be counted for those purposes.

In addition, some changes in mandatory spending are not included on the pay-as-you-go scorecard because they do not directly result from a change in laws governing mandatory programs. Virtually all of the increase in spending in that category--nearly $4 billion over the 1995-2000 period--is the result of the President's proposed pay raises for federal civilian employees and military personnel, which are lower than those provided in current law (see Table 8). Because almost all expenditures for pay are categorized as discretionary, little of the direct effects of the lower pay shows up in mandatory programs. However, the budget category of offsetting receipts--which is considered mandatory--is affected. Federal agencies and the armed services are required to make payments, which are equal to a specified percentage of pay, to the civil service and military retirement trust funds on behalf of civilian employees and

Table 8.
Pay Raises Under CBO's Current-Law Assumptions and the President's Budget (By fiscal year, in percent)

	1996	1997	1998	1999	2000
		CBO's Estimate Under Current Law			
Civilian Raises[a]					
Across-the-board raises	2.4	3.2	3.1	3.0	3.0
Locality raises[b]	3.1	2.4	2.3	2.4	2.4
Total	5.6	5.7	5.5	5.4	5.5
Military Raises	2.4	3.2	3.1	3.0	3.0
		President's Budget Proposal			
Civilian Raises[c]	2.4	3.1	2.1	2.1	2.1
Military Raises	2.4	3.1	3.1	3.1	2.1

SOURCE: Congressional Budget Office.

a. Civilian raises shown apply to General Schedule employees. That group makes up the largest portion of the federal civilian workforce.

b. CBO adjusts locality raises to account for employees who do not receive the full amount of those raises because they are already receiving supplements to their pay.

c. The President's budget does not make any assumptions about how the total annual pay increases it proposes should be distributed between across-the-board raises and locality raises.

military personnel. The payments received by the trust funds are recorded as offsetting receipts, or negative outlays. The President's proposal to reduce future pay increases compared with the raises that would occur under current law would also reduce the amounts received by the retirement trust funds on behalf of the employees--lowering offsetting receipts and increasing net outlays.

Discretionary Spending

CBO has estimated that the total discretionary appropriations proposed by the President would result in outlays that increase by only $11 billion over the next five years--from $550 billion in 1995 to $561 billion in 2000. That total includes both proposed anticrime spending from the Violent Crime Reduction Trust Fund (VCRTF) and all other, or general purpose, appropriations. Total discretionary appropriations in 2000 under the President's proposals are almost 16 percent (about $100 billion) below the level that would be needed to keep pace with inflation, assuming enacted funding for 1995 as the starting point.

CBO estimates that the general purpose discretionary spending proposed by the President is less than the statutory limits in 1996 through 1998 (the limits are scheduled to expire after 1998). If one excludes spending resulting from emergency appropriations proposed in the President's budget (which would result in an adjustment to the limits if enacted), discretionary outlays would be about $2 billion below the limit in 1996, $7 billion below the limit in 1997, and $11 billion below the limit in 1998. The President has proposed reducing the discretionary limits for those years to the levels of discretionary spending in the budget as estimated by the Administration. The budget also recommends extending the limits through 2000 at the levels of spending proposed for those years.

The President's budget proposes specific appropriations from the VCRTF for 1996. The budget authority requested is only $15 million below the $4,287 million available for appropriation from the fund. CBO estimates that outlays will be $204 million below the $2,334 million limit on VCRTF outlays established in the Violent Crime Control and Law Enforcement Act of 1994. The budget does not identify specific VCRTF appropriations for 1997 and later years but instead simply assumes that budget authority and outlays will equal the full amount identified in the crime bill (the budget authority increases to $6,500 million in 2000, and outlays grow to $6,225 million).

The President has also proposed almost $11 billion in 1995 appropriations for emergency purposes. CBO estimates that outlays from those appropriations would equal nearly $2 billion in 1995, more than $1 billion in 1996, and $2 billion a year in 1997 through 1999. Nearly $3 billion of the requested funding would go to the Department of Defense to offset the costs of peacekeeping and humanitarian assistance operations in and around Iraq, Bosnia, Haiti, Cuba, and Korea. Somewhat less than $1 billion would be appropriated for the U.S. share of additional costs of United Nations peacekeeping operations. Almost all of the remaining $7 billion of the requested emergency appropriations would go to the Federal Emergency Management Agency to meet additional costs of the 1994 Northridge earthquake in Southern California and various other disasters in over 40 states.

The President has requested total discretionary budget authority of $538.3 billion for 1996. Excluding the outlay effect of proposed 1995 supplemental appropriations and rescissions (including proposed emergency appropriations), CBO estimates that 1996 outlays resulting from the President's proposals would total $549.4 billion. The President's proposals do not represent a dramatic shift in priorities, but certain areas of the budget fare better than others. The winners and losers can be determined by comparing CBO's estimate of the discretionary appropriations requested by the President for 1996 with its estimate of the level of spending if 1996 appropriations for each account were frozen (with some minor technical adjustments in a few accounts) at the amount appropriated in 1995 (see Table 9).

In order to facilitate the comparison, CBO's freeze has been adjusted to account for a proposed change in the way budget authority is provided for some transportation trust fund programs dealing with highway, mass transit, and air transportation. Under

the current system, the budget authority for those programs is provided in authorizing legislation and is considered mandatory spending. When appropriation bills subsequently impose obligation limits that restrict the use of that budget authority, the outlays for the programs are charged to those bills as discretionary spending. Under the President's proposals, the budget authority would be provided in appropriation bills instead of in the authorizing legislation. To compare its freeze estimate accurately with the President's request for transportation appropriations, which includes budget authority for those programs,

Table 9.
The Administration's Proposals for Discretionary Spending in Fiscal Year 1996 (In billions of dollars)

	Funding at the 1995 Enacted Level as Estimated by CBO		President's Budget as Estimated by CBO[a]		President's Budget Minus 1995 Enacted Level	
	Budget Authority	Outlays	Budget Authority	Outlays	Budget Authority	Outlays
Defense	262.9	263.6	258.3	262.0	-4.6	-1.7
International	20.4	21.1	21.3	21.2	0.9	b
Domestic						
General science, space, and technology	17.1	16.9	17.2	17.0	0.1	0.2
Energy	6.6	6.7	5.9	6.4	-0.6	-0.3
Natural resources and environment	21.6	21.3	22.4	21.7	0.8	0.5
Agriculture	4.0	4.0	4.0	4.1	b	b
Commerce and housing credit	3.4	3.2	3.5	3.2	0.2	b
Transportation[c]	38.4	39.1	36.5	39.0	-1.9	-0.1
Community and regional development	8.8	10.4	9.7	10.9	0.9	0.5
Education, training, employment, and social services	42.0	41.2	44.5	42.6	2.5	1.4
Health	22.8	22.3	23.7	22.6	0.9	0.3
Medicare	3.0	3.0	3.2	3.2	0.2	0.2
Income security	33.6	39.2	33.6	40.4	-0.1	1.2
Social Security	0	2.6	0	3.2	0	0.6
Veterans' benefits	18.3	19.0	19.3	19.1	1.0	0.2
Administration of justice	18.1	17.9	21.5	19.7	3.4	1.8
General government	12.3	12.5	13.7	13.2	1.4	0.7
Subtotal, domestic[c]	250.1	259.3	258.7	266.3	8.6	7.0
Total, discretionary spending[c]	533.4	544.0	538.3	549.4	4.9	5.4

SOURCE: Congressional Budget Office.

a. These figures exclude the effects of proposed 1995 rescissions or supplemental appropriations.

b. Less than $50 million.

c. CBO's projection of budget authority for transportation has been adjusted to reflect a proposed change in the method of providing budget authority from the transportation trust funds for a number of programs.

CBO has increased the freeze estimate by an amount of budget authority equivalent to the 1995 obligational authority for those transportation programs.

In total, the discretionary budget authority requested by the President for 1996 is about $5 billion, or 1 percent, above the level of appropriations enacted for 1995. Proposed defense appropriations, however, are nearly $5 billion (2 percent) below the 1995 level, whereas nondefense appropriations are more than $9 billion (3 percent) higher than in 1995.

Nondefense Discretionary

The largest increase in percentage terms is in the area of administration of justice. Under the terms of the Violent Crime Control Act, nearly $2 billion more can be appropriated from the Violent Crime Reduction Trust Fund for 1996 than is available in 1995. The President's budget proposes using virtually all of the funds available, significantly increasing spending in the administration of justice category. Other categories with relatively large proposed increases over 1995 funding levels include general government and community and regional development. About half of the proposed $1.4 billion increase for general government activities is for the Internal Revenue Service. The growth in community and regional development funding primarily reflects a proposed increase in appropriations for rural development programs.

The largest reduction below the 1995 appropriated level in percentage terms is in the energy area. However, more than half of the proposed $600 million cut comes from eliminating discretionary appropriations from the Nuclear Waste Fund, which is part of the Administration's proposal to begin funding nuclear waste activities through a mandatory account. The next largest reduction is in the funding requested for transportation programs. As noted above, the President has proposed a significant change in the way funds from the transportation trust funds are made available. In addition to having the spending authority provided directly in appropriation bills, the President has proposed a restructuring of the accounts through which the funds flow. When that restructuring is taken into account, and the 1995 appropriations are adjusted to conform to the approach of the 1996 proposal, the President's proposal for 1996 transportation funding is $2 billion below the funding provided in 1995.

Defense Discretionary

The President has requested $258 billion in funding for defense programs in 1996 and about $1.3 trillion over the 1996-2000 period. Defense appropriations would continue to fall through 1997; the proposed increases after that would about keep pace with inflation. The proposed defense budget would support a force of about 1.4 million people in uniform on a full-time basis and an additional 0.9 million part-time or reserve personnel. Those forces would serve in 13 active Army and Marine Corps divisions, 42 reserve brigades, 358 Navy ships (including 12 aircraft carriers), and 13 active and 7 reserve Air Force air wings. The budget provides sufficient funding to maintain training rates and keep equipment in good repair--both of which are necessary to ensure that the forces are ready to fight on short notice. In order to modernize weaponry, the budget would boost procurement funding beginning in 1997, with an especially large increase in 1998.

Last year there was concern that the President's fiscal year 1995 budget request for defense spending in 1996 through 1999 was not sufficient to fund the plan put forward by the Department of Defense. CBO attributed that potential underfunding to the failure of the budget request to provide fully for the general inflation assumed by the Administration, pay raises for military and civilian personnel, growth in the cost of weapons, base closing costs, quality-of-life improvements, and contingency operations.

The President's 1996 budget has substantially reduced the potential funding gap. The Administration has lowered its forecast of inflation since last year--reducing the difference between the assumptions supporting the budget and those used in preparing the Department of Defense plan. In addition, the new budget added $10 billion in 1996-1999 funding ($25 billion through 2002) for the out-year costs of 1995

pay raises and for other expenses such as child care, maintenance of facilities, and purchases of munitions.

In total, however, the request for defense funding for the 1996-1999 period is only $7 billion higher than it was a year ago. Therefore, the reduction in the potential underfunding has been achieved primarily by assuming lower spending in other areas of the defense budget. For instance, plans for closing bases have been scaled back, reducing the one-time costs associated with those closings. More important, the fiscal year 1996 budget includes about $28 billion less for procurement than was requested last year. Proposed funding for procurement in 1996 alone is $9 billion lower than previously planned: Navy funding for weapons has plunged by nearly $5 billion (25 percent), Air Force funding is down by $4 billion (18 percent), and Army funding has fallen by $1 billion (10 percent).

The Department of Defense would save about $6 billion in 1996 through 1999 by cancellations or delays in several major programs:

- The Tri-Service Standoff Attack Missile was cancelled.

- No Comanche helicopters will be bought after two prototypes are produced.

- Purchases of a new attack submarine, new destroyers (DDG-51s), the V-22 Osprey aircraft, an advanced amphibious assault vehicle, and the F-22 fighter aircraft will be stretched out over a longer period of time than planned earlier.

Some of those changes are the result of problems with the weapons (for instance, the failure of the Tri-Service Standoff Attack Missile to meet specifications and stay within planned costs) or revised estimates of needs. Other changes, however, are clearly the result of attempts to make defense plans conform to budgetary constraints.

Chapter Four

The Administration's Revenue Proposals

The Congressional Budget Office estimates that revenue would grow from $1.355 trillion this year to $1.678 trillion in 2000 under the policies included in the President's budget (see Table 10). As a percentage of gross domestic product, revenue is projected to fall from 19.3 percent this year to 18.6 percent in 2000. Enacting the President's proposals would reduce revenues by $2 billion in 1996 and by $20 billion, or 0.2 percent of GDP, in 2000, but would add $0.1 billion to revenues in 1995 (see Table 11).

The two largest proposed tax cuts--a tax credit for dependent children and a new deduction for education and training expenses--would not be fully effective until tax returns are filed in 2000. Revenue losses would also be limited in the early years because the proposal to expand individual retirement accounts (IRAs) would bring in revenues if, as expected, taxpayers transfer their existing IRA funds to the new IRAs proposed by the Administration. After 2000, revenue losses would no longer increase faster than incomes, except for losses from the proposed IRA, which can be expected to accelerate over time.

Under the current pay-as-you-go limits, the $60 billion of net tax reduction proposed by the Administration would have to be offset by cuts in mandatory spending or increases in other taxes. If the Administration's revenue proposals became law without legislation offsetting the tax reduction or modifying the pay-as-you-go rules, automatic cuts in mandatory spending would be triggered.

The Joint Committee on Taxation (JCT) prepared the estimates for the Administration's revenue proposals, except for those involving fees. CBO provided the estimates for fees. As a whole, the JCT and CBO estimates are similar to the Administration's.

Tax Relief for Middle-Income Families

The major tax initiative in the President's budget aims to reduce taxes for middle-income families. The Administration proposes to provide tax relief for middle-income families through a nonrefundable tax credit for families with young children, a deduction for postsecondary education and training expenses, and expanded benefits for saving through IRAs. The JCT estimates that the three proposals together would cost $66 billion over the next five years.

Tax Credit for Families with Young Children

The Administration proposes a nonrefundable tax credit for each dependent child under the age of 13. The credit would be phased in at $300 per child for 1996, 1997, and 1998, and $500 per child in 1999 and thereafter. The credit would be applied to any remaining tax liability after the earned income tax credit and would be reduced for families with adjusted gross income (AGI) between $60,000 and $75,000. Families with AGI of $75,000 or more would not be eligible for the credit. The amount of the credit and the phaseout range would be indexed for inflation beginning in 2000.

Few families with adjusted gross income below $20,000 would receive the credit. Because it is nonrefundable, the credit would not be available to families that owe no federal income taxes. Few families with income below $20,000 owe income tax once the earned income tax credit is applied.

The JCT estimates that the Administration's proposed credit would cost $1.4 billion in 1996 and $33.4 billion over five years (see Table 12). The annual cost of the credit would rise to $10.6 billion in 2000, by which time the full $500 credit would apply. The JCT assumes that fewer families would take immediate advantage of the credit by adjusting their withholding rather than realizing the benefits when their taxes come due in the following year. That factor reduces the cost of the credit initially and when the credit amount increases from $300 to $500 but has little impact in later years.

Title VI of the Tax Fairness and Deficit Reduction Act of 1995 (H.R. 1215) also proposes a family

Table 10.
CBO's Estimates of Revenues Under the President's Proposals (By fiscal year)

Source	1995	1996	1997	1998	1999	2000
			In Billions of Dollars			
Individual Income	594	625	644	679	715	752
Corporate Income	149	151	156	162	168	173
Social Insurance	494	517	539	565	590	618
Excise	56	56	57	58	59	59
Other	63	67	68	70	72	75
Total	1,355	1,416	1,464	1,534	1,604	1,678
On-budget	998	1,041	1,072	1,122	1,173	1,226
Off-budget	357	375	392	411	431	452
Memorandum:						
Gross Domestic Product	7,036	7,370	7,747	8,152	8,572	9,013
			As a Percentage of GDP			
Individual Income	8.4	8.5	8.3	8.3	8.3	8.3
Corporate Income	2.1	2.1	2.0	2.0	2.0	1.9
Social Insurance	7.0	7.0	7.0	6.9	6.9	6.9
Excise	0.8	0.8	0.7	0.7	0.7	0.7
Other	0.9	0.9	0.9	0.9	0.8	0.8
Total	19.3	19.2	18.9	18.8	18.7	18.6
On-budget	14.2	14.1	13.8	13.8	13.7	13.6
Off-budget	5.1	5.1	5.1	5.0	5.0	5.0

SOURCE: Congressional Budget Office.

tax credit. Although the Administration's proposal and H.R. 1215 would both provide a $500 credit for each dependent, the two specify eligibility for the credit in significantly different ways. The Administration's proposal would limit eligibility for the full credit to families with AGI under $60,000; H.R. 1215 would limit it to families with AGI under $200,000 (the tax credit would phase out over a $50,000 income range for families with AGI in excess of $200,000). The Administration's proposal would allow a credit for each dependent child under the age of 13; H.R. 1215 would allow a credit for each dependent child under age 18. The Administration's proposal would not allow families to receive the credit if the earned income tax credit (EITC) eliminated their tax liability; H.R. 1215 would allow families to claim the credit if tax liability was positive before applying the EITC.

The family tax credit in H.R. 1215 would cost more than the Administration's proposal (about two and one-half times as much on an annual basis by 2000) because more families would be eligible and the average amount received per family would be higher. Those differences would occur because of the higher income limit, because families with children 13 to 17 years old would qualify, and because the credit would apply to tax liability before the EITC.

The Administration's proposal would raise the after-tax income of families with children by a small amount--an average of between 1 percent and 2 percent for eligible families with income between $20,000 and $75,000. Although additional after-tax income could cause some parents to reduce the number of hours they worked, such small changes in after-tax income would not lead to a significant labor market response. Phasing out the credit for higher-income families would raise their marginal tax rates. The approximately 3 million families who have income between $60,000 and $75,000 and who are eligible for the credit would see an increase in their marginal tax rate of about 3 percentage points for each eligible child once the $500 per child credit was payable. Higher marginal tax rates are a consequence of any phaseout of benefits that is conditional on income.

Tax Deduction for Education and Job Training

The Administration proposes a deduction for qualified expenses for postsecondary education. Taxpay-

Table 11.
Comparison of Revenue Estimates of the President's 1996 Budgetary Proposals
(By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	1995-2000
CBO/JCT	0.1	-2.1	-11.3	-12.6	-14.5	-19.5	-59.9
Administration	a	-3.0	-10.4	-10.9	-13.6	-18.1	-56.0
Difference	0.1	0.9	-0.9	-1.6	-0.9	-1.4	-3.9

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: JCT = Joint Committee on Taxation.

a. Less than $50 million.

ers would be allowed to deduct the expenses of education and training for themselves, their spouses, or their dependents. The maximum deduction would be $5,000 in 1996, 1997, and 1998, and $10,000 in 1999 and thereafter. The deduction would be phased out for couples with income between $100,000 and $120,000 and for single taxpayers with income between $70,000 and $90,000. The income phaseout range would be indexed for inflation beginning in 2000.

The deduction would apply to adjusted gross income. Thus, in order to qualify for the new deduction, taxpayers would not need to itemize deductions or meet the current floor of 2 percent of AGI that applies to certain deductible education and other business-related expenses under current law.

The deduction would apply to qualified education expenses, defined as tuition and fees directly related to a course of studies for which an eligible student is

Table 12.
Comparison of Revenue Estimates of the President's 1996 Budgetary Proposals to Provide Tax Relief to Middle-Income Families (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	1995-2000
			Tax Credit for Families with Young Children				
CBO/JCT	0	-1.4	-7.0	-6.9	-7.5	-10.6	-33.4
Administration	0	-3.5	-6.8	-6.6	-8.3	-10.1	-35.4
			Education and Training Tax Deduction				
CBO/JCT	0	-1.7	-5.0	-6.0	-6.7	-7.0	-26.4
Administration[a]	0	-0.7	-4.7	-4.9	-5.7	-7.5	-23.5
			Expanded Individual Retirement Accounts				
CBO/JCT	0	0.2	-0.4	-1.0	-1.7	-3.4	-6.3
Administration	0	0.4	-0.3	-0.8	-1.0	-2.0	-3.8
			Total Tax Relief for Middle-Income Families				
CBO/JCT	0	-2.9	-12.5	-13.8	-15.9	-21.0	-66.1
Administration	0	-3.8	-11.8	-12.4	-15.1	-19.6	-62.7

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: JCT = Joint Committee on Taxation.

a. After the budget was published, the Treasury Department issued slightly revised estimates of this provision. The revised estimates are -$5.0 billion in 1998, -$5.8 billion in 1999, and -$7.6 billion in 2000.

enrolled on at least a half-time basis. The deduction would not be allowed for expenses associated with meals, lodging, student activities, health care, transportation, books, and other living expenses. The amount of qualified expenses would be reduced by any nontaxable education assistance, such as certain scholarships and fellowships.

The Joint Committee on Taxation estimates that the deduction would cost $26 billion over five years and $7 billion in 2000 (see Table 12).

At current levels of enrollment, about 60 percent of the students eligible to claim the deduction would come from families with income of $50,000 or less. Because students from higher-income families tend to have higher tuition expenses on average, the 40 percent of students from families with income of $50,000 or more would claim about 50 percent of the total deductions.

As with all deductible expenditures, the education deduction would provide greater tax relief for families in higher tax brackets than for those in lower tax brackets. A $10,000 deduction would save $2,800 in taxes for a family in the 28 percent bracket, but $1,500 for a family in the 15 percent bracket. The deduction would not benefit families with income too low to owe taxes, although most such families already qualify for existing federal education assistance.

Some of the benefits from the deduction would go to schools if they took advantage of the deduction to raise tuition without increasing the after-tax cost to students. Research on previous increases in federal educational assistance has shown only a weak link between increased aid and higher tuition levels. Because the proposed deduction would be available to most students, however, schools could raise tuition without making many students worse off. A significant number of schools might choose to adopt that course.

Because the deduction would have to be taken in the year in which educational expenses are paid, students who finance their own education with loans would receive no tax benefits. The deduction would do them little good while they are in school and have little income and hence little or no tax liability, and would not be available later when they are working and paying back a loan. Allowing students to deduct repayment of principal and interest later on student loans would provide them with equal treatment but would also add to the cost of the proposal.

Because the $10,000 deduction would be phased out over a relatively narrow range of income, the proposal would significantly increase marginal tax rates for eligible families who have income in that range; for example, by 14 percentage points for a family in the 28 percent bracket. Only families that choose to take the deduction and have income in the phaseout range would be affected.

Expanded Individual Retirement Accounts

The Administration proposes to expand eligibility for deductible individual retirement accounts, establish new "special IRAs," and allow penalty-free withdrawals from regular IRAs for certain qualified purposes.

Extend Eligibility for Deductible IRAs. Under current law, a taxpayer may make a tax-deductible contribution to an IRA of up to a $2,000 a year. The amount contributed cannot exceed the taxpayer's earnings. If the taxpayer or the taxpayer's spouse is an active participant in an employer-sponsored retirement plan, the $2,000 limit is reduced by $1 for every $5 of income in excess of $40,000 for a couple and $25,000 for a single taxpayer. Thus, couples with an income of $50,000 or more and singles with an income of $35,000 or more cannot make deductible contributions. If taxpayers cannot make fully deductible contributions because their income exceeds those limits, they can nevertheless contribute to a nondeductible IRA.

Investment income in an IRA is tax-exempt while it accrues. A taxpayer must include in taxable income the full amount of withdrawals from an account (withdrawals from a nondeductible IRA are only included in taxable income insofar as they exceed the original contributions). An additional 10 percent penalty generally applies to withdrawals made before age 59½.

The Administration proposes to double the income limits for deductible contributions to $80,000 for a couple and $50,000 for a single taxpayer. The proposal would also double the phaseout range from $10,000 to $20,000. The income limits, the phaseout range, and the current annual contribution limit of $2,000 would be indexed for inflation.

Establish Special IRAs. The Administration also proposes to establish new special IRAs. Taxpayers who are eligible for regular deductible IRAs could choose to contribute an amount up to the contribution limit to either a deductible or a special IRA. Contributions to a special IRA would not be tax-deductible, but taxpayers could withdraw contributions and earnings that remained in the account for a least five years tax-free and with no penalties. Earnings taken out before they had been in the account for five years would be subject to income taxes. An additional 10 percent penalty would apply to those early withdrawals of earnings unless the money withdrawn was used for certain purposes. Taxpayers eligible for special IRAs could transfer balances in deductible IRAs to special IRAs penalty-free, but those transfers would be subject to tax. Transfers made before January 1, 1997, could be included in taxable income spread evenly over four years.

Allow Penalty-Free Withdrawals for Certain Expenditures. The Administration proposes to allow penalty-free withdrawals of funds from a regular IRA as well as funds held in a special IRA less than five years if the money is used for postsecondary education, to buy a first home, to cover living costs if unemployed, or to pay for catastrophic medical expenses (including some nursing home costs).

The Joint Committee on Taxation estimates that the proposal to expand IRAs would cost $6.3 billion over five years. The proposal would raise revenues in the first year as holders of regular IRAs transfer funds to special IRAs (and pay taxes on those transfers), and those additional revenues would offset some of the costs through 1999. The proposal would cost $3.4 billion by 2000 and increase in cost thereafter. Although the Administration projects that the proposal to expand IRAs would cost somewhat less--about $4 billion over five years--the differences in the estimates are quite small in view of the range of uncertainty. The projections depend on estimates of the amount of contributions by newly eligible taxpayers, whether taxpayers will choose to contribute to regular or special IRAs, the amount of funds that will be transferred from existing IRAs to special IRAs, and when people will withdraw funds from special IRAs.

The Administration's proposal differs from the proposal to expand IRAs in title VI of the Tax Fairness and Deficit Reduction Act. That bill would not change existing IRAs but would create new American Dream Savings Accounts (ADSAs). As with special IRAs, contributions (up to $2,000 per taxpayer) to an ADSA would not be tax-deductible, but withdrawals would not be included in taxable income. If withdrawals were made before age 59½, the portion attributable to investment earnings would be subject to income tax and a 10 percent penalty unless the ADSA had been in existence for at least five years and the withdrawals were used for higher education expenses, a first-time home purchase, or medical expenses. There would be no income limits for eligibility to contribute to an ADSA. A taxpayer could contribute up to $2,000 to both an ADSA and an IRA, a total of $4,000. Taxpayers could transfer funds from an existing deductible IRA to an ADSA. Transfers would be penalty-free but taxable.

The new special IRAs proposed by the Administration and the American Dream Savings Accounts are examples of back-loaded tax-favored savings accounts. They are back-loaded because contributions are not tax-deductible when they are made but, together with accumulated earnings, are not taxable when withdrawn from the account. By contrast, regular IRAs are front-loaded because contributions are initially tax-deductible but, together with accumulated earnings, are taxable when withdrawn.

As long as taxpayers are in the same marginal tax bracket when they make contributions to an IRA and when they withdraw funds at retirement, the economic benefits of a front-loaded and a back-loaded account are the same. For example, 40-year-old workers in the 15 percent tax bracket who make a $1,000 contribution to a deductible (front-loaded) IRA will have $3,870 in their accounts at age 60 if they earn a 7 percent annual return on their investment. After paying taxes--assuming they are still in the 15 percent bracket--they will have $3,289 to

spend. If those workers chose instead to open a nondeductible (back-loaded) IRA with their $1,000, they would have $850 to deposit in the account after paying taxes. When the workers reached the age of 60, that investment would have grown to $3,289 and, owing no additional taxes, they would have that amount to spend.

Back-loaded IRAs can be more advantageous than front-loaded IRAs when both have the same annual contribution limit. For back-loaded and front-loaded IRAs with the same contribution limit, investors can place the equivalent of more before-tax income in the back-loaded IRA. Thus, back-loaded IRAs have higher effective limits, as taxpayers can accumulate more retirement savings tax-free with the back-loaded IRA.

Estimates of the cost of special IRAs and ADSAs anticipate a pickup in revenue initially as taxpayers transfer funds from regular IRAs, pay tax on those transfers, and deposit the after-tax proceeds in the new accounts. Some taxpayers would be willing to make the transfer, trading a front-loaded account for a back-loaded account, because both special IRAs and ADSAs offer the advantage of penalty-free withdrawals much sooner then regular IRAs. The revenue increase represents an acceleration of taxes that would have been paid in the future and thus a corresponding revenue loss outside the five-year projection period in the budget.

In addition to the effect from accelerating future revenues into the five-year budget period, the long-term revenue loss from special IRAs will grow over time. Special IRAs differ from ordinary taxable accounts because earnings on contributions are not taxed. Since it would take some time for funds to build up in special IRAs, the revenue loss would be small initially but would grow as funds accumulated in those accounts. By contrast, the government loses more revenue initially from deductible IRAs, when taxpayers make tax-deductible contributions.

The government loses revenues from special IRAs or regular deductible IRAs because it would have collected taxes on annual investment earnings if those funds were saved in ordinary taxable accounts. If the funds contributed to IRAs come from money that would have been spent and not saved in ordinary taxable accounts, there is no revenue loss from IRAs.

The Administration's proposal would increase the amount saved in IRAs, but how much of that would be an increase in total personal saving and not a shift of funds from taxable saving is unclear. People may respond initially by transferring assets from other savings to IRAs and receive the full tax benefit. Eventually, many people will exhaust existing savings to transfer, and contributions to IRAs will come from new saving. Whether this new saving would be greater than the amount that people would have saved without the additional tax incentives is also unclear. People who had planned to save at least as much as the contribution limit to IRAs would not receive a tax advantage for additional saving and thus should not be expected to increase saving. Higher-income families, the group made eligible for IRAs under the Administration's proposals as well as for ADSAs, are more likely to have planned to save at least as much as the contribution limit.

For people with little other savings to transfer to IRAs and who would have saved less than the amount of the contribution limit, the tax advantages of IRAs would raise the after-tax rate of return from saving, which would encourage them to save more than they would have otherwise, because each dollar of saving could buy more in the future. Since the after-tax rate of return would be higher, however, people would have to save less in order to reach some savings goal. The net effect could be an increase in saving, but it could also be no change or even a decrease. The evidence on how people respond to changes in after-tax rates of return is mixed, but most studies suggest a small increase in saving in response to an increase in the after-tax rate of return.

IRAs are thought to promote saving in other ways, aside from the way in which people respond to a change in the after-tax return from saving. The penalty for early withdrawals encourages the use of IRAs to save for retirement, making those accounts less like other forms of saving and making it less likely that people will use them as substitutes for nonretirement saving. Tax deductible contributions (front-loading) of regular deductible IRAs are thought to encourage contributions at the expense of

current consumption because it is easier for people to perceive the immediate benefit of the deduction--for example, when faced with the choice between making a tax payment on April 15th or depositing their money in an IRA and reducing their tax bill.

Special IRAs (and ADSAs) do not have those possible added inducements for saving. They broaden the purposes for which taxpayers can make withdrawals free of penalties, making the accounts more like other forms of saving and increasing the likelihood that more contributions to the new accounts will come from transfers from other saving instead of reduced consumption. Special IRAs (and ADSAs) do not allow tax-deductible contributions, but if certain conditions are met, all withdrawals will be tax-free. Although back-loaded benefits such as those offered by special IRAs and ADSAs are economically equivalent to those offered by regular deductible IRAs, they do not provide the psychological inducement of an immediate reduction in taxes.

Although research and experience have produced mixed messages about the effect of IRAs on saving, the conclusion that IRAs increase private savings by only a small amount cannot be ruled out. The Administration's proposals (and ADSAs) contain features that make them less likely to increase private savings than existing IRAs. Because the revenue loss from the proposal grows over time, if the private savings response is small the net effect may be to reduce national savings (the sum of public and private savings) in the long run.

Table 13.
Comparison of Revenue Estimates of the President's 1996 Budgetary Proposals to Modify Eligibility Rules for the Earned Income Tax Credit (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	1995-2000
			Earned Income Tax Credit Compliance Proposals[a]				
CBO/JCT	0	b	b	b	b	b	0.1
Administration	0	b	0.1	0.1	0.1	0.1	0.4
			Interest and Dividend Test for Earned Income Tax Credit[c]				
CBO/JCT	0	b	0.1	0.1	0.1	0.1	0.3
Administration	0	b	0.1	0.1	0.1	0.1	0.3

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: JCT = Joint Committee on Taxation.

a. Changes in outlays are included in Chapter 3. Earned income tax credit outlays would decrease by $10 million in 1996 and by $0.2 billion per year in 1997 through 2000.

b. Less than $50 million.

c. Changes in outlays are included in Chapter 3. Earned income tax credit outlays would decrease by $13 million in 1996 and by $0.3 billion per year in 1997 through 2000.

Modifying the Earned Income Tax Credit Eligibility Rules

The Administration proposes two changes in the eligibility rules for the EITC. The first is intended to focus the credit more sharply on families with low earnings and little other economic resources by denying it to families with income from interest and dividends of $2,500 or more. The second proposal would prevent individuals who are not authorized to work in the United States from receiving the credit. The proposals would have a small effect on revenues (see Table 13). The main effect would be to reduce outlays by reducing earned income tax credit refunds.

Interest and Dividend Test for the Earned Income Tax Credit

The EITC is payable to taxpayers who have modest amounts of income from wages or self-employment. The amount of the credit depends on the level of earnings and whether the taxpayer has one, two or more, or no qualifying children. Earnings (or if greater, adjusted gross income) above certain thresholds reduce the amount of the credit. The EITC is a refundable credit, payable to taxpayers even if it exceeds the amount of their tax liability.

Under current law, taxpayers can receive the earned income tax credit even though they have significant amounts of income from interest and dividends. A family with one qualifying child, for example, could receive the maximum credit even though it had more than $5,000 in income from interest and dividends.

The Administration proposes to deny the EITC to taxpayers who receive more than $2,500 in annual interest and dividend income beginning in 1996. The $2,500 threshold would be indexed for inflation in subsequent years.

The Administration's proposal does not allow for a phaseout of the credit if interest and dividend income exceed the $2,500 threshold by a small amount. Because families with interest and dividend income just over the threshold would lose the entire credit, they would have a strong incentive to rearrange their assets so as to reduce their interest and dividend income below $2,500.

The Congress has already passed H.R. 831, the Self-Employed Health Insurance Act of 1995. That act includes a provision similar to the Administration's proposal, but would deny the EITC to taxpayers who receive interest and dividend income in excess of $2,350. The $2,350 threshold would not be indexed for inflation.

Earned Income Tax Credit Compliance Proposal

Under current rules, a taxpayer must live in the United States for more than six months to be eligible for the EITC. Beginning in 1995, nonresident aliens are not entitled to the credit. The Administration proposes to tighten compliance procedures so that illegal aliens or those who do not have the proper documentation for employment purposes would be denied the earned income tax credit.

Other Revenue Proposals

The Administration's budget includes other revenue proposals (see Table 14). Two proposals, aimed at increasing the number of empowerment zones and reducing the vaccine excise tax, would reduce revenues by a small amount. The remaining proposals would raise revenues by tightening the rules for taxing income from foreign trusts, limiting opportunities for tax avoidance by U.S. citizens who renounce their citizenship, increasing bank examination fees and fees charged under the securities laws, and reauthorizing the corporate environmental income tax used to finance the cleanup of hazardous waste sites. CBO estimates that those proposals together would increase revenues by about $6 billion over the next five years, or about $1 billion less than the amount projected by the Administration.

Table 14.
Comparison of Revenue Estimates of Other Tax Provisions in the President's 1996 Budget
(By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	1995-2000
				Increase Number of Empowerment Zones			
CBO/JCT	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.7
Administration	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.7
				Reduce Excise Tax on Certain Vaccines			
CBO/JCT	0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4
Administration	0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3
				Tax Unrealized Capital Gains of Americans Who Renounce Citizenship			
CBO/JCT	0.1	0.2	0.2	0.3	0.4	0.5	1.7
Administration	0	0.1	0.2	0.3	0.4	0.5	1.5
				Revise Taxation of Foreign Trusts			
CBO/JCT	0.1	0.2	0.2	0.2	0.2	0.2	1.1
Administration	0	0.3	0.4	0.4	0.5	0.5	2.0
				Extend Corporate Environmental Income Tax			
CBO/JCT	0	0.3	0.5	0.5	0.6	0.6	2.5
Administration	0	0.3	0.5	0.5	0.5	0.5	2.4
				Increase or Expand Fees Collected Under Securities Laws			
CBO/JCT	0.1	0.2	0.2	0.3	0.3	0.3	1.3
Administration	0.1	0.3	0.3	0.3	0.4	0.4	1.8
				Impose Fees on State Chartered Banks			
CBO/JCT	0	0.1	0.1	0.1	0.1	0.1	0.3
Administration	0	0.1	0.1	0.1	0.1	0.1	0.4
				Limit Pay Raises for Federal Employees			
CBO/JCT[a]	0	0	0	0	0	0	0
Administration	0	-0.1	-0.2	-0.3	-0.4	-0.5	-1.3

Memorandum:
After the budget was published, the Treasury Department issued corrected estimates of the following two provisions. The earlier estimates were based on a later effective date than the final proposal. The revised estimates are:

	1995	1996	1997	1998	1999	2000	1995-2000
				Tax Unrealized Capital Gains of Americans Who Renounce Citizenship			
	0.1	0.2	0.3	0.4	0.5	0.7	2.2
				Revise Taxation of Foreign Trusts			
	0.1	0.3	0.5	0.5	0.5	0.6	2.4

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: JCT= Joint Committee on Taxation.

a. As a result of proposals to limit future increases in federal pay, the Administration assumes a decrease in federal employee contributions to the Civil Service Retirement System and the Federal Employees' Retirement System. Under Congressional scorekeeping rules, revenue estimates are not adjusted for changes in discretionary appropriations.

Increase the Number of Empowerment Zones

The Administration would authorize the designation of two additional urban empowerment zones. The Omnibus Budget Reconciliation Act of 1993 provided tax incentives for nine empowerment zones and 95 enterprise communities. Businesses located in an empowerment zone receive such tax advantages as tax credits, more liberal write-off of investment expenses, and access to subsidized borrowing.

Reduce Vaccine Excise Taxes

The Administration proposes a reduction in manufacturers' excise taxes on certain vaccines. Net revenues from vaccine excise taxes are deposited in the Vaccine Injury Compensation Trust Fund and used to compensate individuals who are injured by those vaccines. The trust fund has accumulated a large balance, and at current rates, transfers to the fund will continue to exceed outlays. A decrease in taxes will still allow the fund to provide compensation.

Tax Unrealized Capital Gains of Americans Who Renounce Citizenship

By relinquishing U.S. citizenship, a U.S. taxpayer can avoid tax on unrealized capital gains that were earned while he or she was a citizen. The Administration proposes that when a U.S. citizen renounces citizenship, that individual's assets will be treated as if a transaction occurred in which all gains and losses were realized and subject to tax. The provision would exempt the first $600,000 in gains.

Revise Taxation of Income from Foreign Trusts

The Administration proposes to tighten the rules for taxing foreign trust income of U.S. taxpayers. The proposals would strengthen reporting requirements for U.S. taxpayers who transfer property to foreign trusts and limit opportunities to defer or completely avoid tax on income from such trusts. The proposals would reduce the tax incentives to establish and maintain foreign trusts by treating domestic and foreign trusts in a more even-handed way.

Extend Corporate Environmental Income Tax

The Administration proposes to extend the environmental tax on corporate taxable income that is scheduled to expire on December 31, 1995. Under current law, a tax of 0.12 percent of alternative minimum taxable income in excess of $2 million is levied on all corporations and deposited in the Hazardous Substance Superfund. Monies from the fund are used to clean up hazardous waste sites.

Increase or Expand Fees Collected Under Securities Laws

The Administration proposes a multitiered structure of increases in fees collected under the securities laws to fund the continuing operations of the Securities and Exchange Commission and reduce the deficit. Some of the increases would be classified as governmental revenues and some would be offsetting collections.

Impose Fees for Examination of State-Chartered Banks

Depository institutions such as thrifts, credit unions, and nationally chartered banks all pay a bank examination fee to the federal agency that supervises them. The Administration proposes to require state-chartered banks that are not members of the Federal Reserve System to pay examination fees to the Federal Deposit Insurance Corporation. Under the proposal, state-chartered member banks of the Federal Reserve System would pay examination fees to it.

Because the Federal Reserve would no longer be required to fund the cost of bank examinations from earnings, earnings of the Federal Reserve, which are classified as government revenues, would increase. Fees collected by the Federal Deposit Insurance Corporation are classified as offsetting receipts and are not counted as part of revenues.

Appendixes

Appendix A

CBO's Baseline Budget Projections

Throughout this report, the Administration's proposals are contrasted with the Congressional Budget Office's (CBO's) baseline estimates of the budget. Those estimates show the path of revenues and spending if current laws and policies remain unchanged. They are not forecasts of budget outcomes, since policymakers will certainly seek to alter current priorities. But these current-policy estimates serve as handy yardsticks for gauging the potential impact of proposed changes--those advocated in the President's budget as well as in competing packages.

The Baseline Concept

Baseline projections follow some general rules. Revenues and entitlement programs (like Social Security and Medicare) continue on their course until the Congress changes the laws that underpin them--laws that define taxable income and set tax rates, benefit formulas, eligibility, and so forth. For those categories, therefore, the baseline represents CBO's best estimate of what will happen in the absence of any changes to current laws.

Discretionary programs, unlike entitlement programs, are funded anew each year through the appropriation process. Discretionary programs encompass nearly all spending for defense and international affairs plus many domestic programs--for space, energy, highway and airport grants, environmental protection, and health research, to name just a few--as well as the salaries and expenses of civilian agencies. The Budget Enforcement Act of 1990 set caps on total discretionary spending for the 1991-1995 period, and the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) extended them through 1998. CBO's baseline assumes compliance with the caps, which, as explained below, will force trade-offs among many competing programs. No law specifies caps after 1998. Thus, for 1999 and 2000, CBO produces two alternative projections of discretionary spending. One set of baseline projections preserves discretionary spending at the same real level as in 1998, increasing it by around 3 percent a year to account for inflation. The other set of projections assumes that discretionary spending is frozen at the 1998 dollar level.

Three categories of spending remain. The federal government has pledged to protect depositors in banks and savings and loan institutions, and the baseline for deposit insurance shows the net cost of meeting those promises. The category labeled offsetting receipts, which encompasses Medicare insurance premiums and similar fees and collections, represents CBO's best estimate of the amounts that the government will collect under current laws and policies. The last category is net interest, which is driven by market interest rates and future deficits rather than being directly controlled by policymakers; CBO estimates such spending consistent with its projections of those two fundamental determinants.

Baseline Projections

In January, CBO published its baseline projections in *The Economic and Budget Outlook: Fiscal Years 1996-2000* and described the key factors that drive the federal government's revenues, spending, and

deficit. Since then, CBO has revised its baseline projections modestly in the face of new information. Those revisions raise projected deficits in every year after 1995 (see Table A-1).

Because CBO has not updated its economic forecast and no new legislation has affected outlay projections since January, all changes to the baseline fall into the technical category. Technical revisions stem from new information that has come to light through late February, much of it contained in the President's budget and supporting documents.

The largest technical revision reflects adjustments made by the Office of Management and Budget (OMB) to the discretionary spending caps specified in OBRA-93. CBO conforms its baseline for total discretionary spending to the most recent official limits published by OMB. Ordinarily, there are only small differences between CBO's previous estimate of the limits and OMB's official limits. In this instance, however, different interpretations of a provision in OBRA-93 led to OMB limits that are significantly higher than CBO's estimates. Instead of continuing to adjust the caps for the difference between

Table A-1.
Changes in CBO's Baseline Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
January Baseline Deficit with Discretionary Inflation After 1998[a]	176	207	224	222	253	284
Technical Revisions						
Discretionary spending[b]	4	3	6	9	9	10
Mandatory spending						
Medicaid	-1	-1	-1	-1	-1	-1
Medicare	2	3	3	3	2	2
FHA mutual mortgage insurance	-3	-4	-3	-3	-1	c
FCC spectrum auctions	-3	0	c	c	0	-1
Other	-1	c	c	c	1	3
Subtotal	-6	-2	-1	-1	1	2
Deposit insurance	c	2	1	c	c	c
Interest	1	c	1	1	2	3
Total Revisions	-1	3	6	10	13	15
March Baseline Deficit with Discretionary Inflation After 1998[a]	175	210	230	232	266	299

SOURCE: Congressional Budget Office.

NOTE: FHA = Federal Housing Administration; FCC = Federal Communications Commission.

a. Projections assume that discretionary spending is equal to the spending limits that are in effect through 1998 and equal to the 1998 limit adjusted for inflation after that.

b. The changes in 1996 through 2000 are the result of differences between CBO's January estimate of the discretionary spending limits for 1996 through 1998 and the official limits presented in the President's budget.

c. Less than $500 million.

Table A-2.
CBO's Deficit Projections (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	175	210	230	232	266	299
Without discretionary inflation after 1998	203	175	210	230	232	247	258
Standardized-Employment Deficit[a]							
With discretionary inflation after 1998	187	199	218	229	230	260	289
Without discretionary inflation after 1998	187	199	218	229	230	241	248
On-Budget Deficit (Excluding Social Security and Postal Service)							
With discretionary inflation after 1998	259	243	283	309	317	355	395
Without discretionary inflation after 1998	259	243	283	309	317	336	354
Memorandum:							
Deposit Insurance	-8	-16	-8	-4	-5	-3	-2
Cyclical Deficit	23	-8	b	5	6	10	13
Off-Budget Surplus							
Social Security	57	69	73	78	84	89	95
Postal Service	-1	b	b	1	1	b	1
Total	56	69	73	79	85	89	96
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.9	3.0	2.8	3.1	3.3
Without discretionary inflation after 1998	3.1	2.5	2.9	3.0	2.8	2.9	2.9
Standardized-Employment Deficit[a,c]							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.8	3.0	3.2
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.8	2.8	2.7

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and deposit insurance.

b. Less than $500 million.

c. Expressed as a percentage of potential gross domestic product.

Table A-3.
CBO's Baseline Budget Projections with Discretionary Inflation After 1998 (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
Revenues							
Individual income	543	594	628	656	693	731	772
Corporate income	140	149	151	155	161	167	173
Social insurance	461	494	517	539	565	590	618
Other	113	119	122	125	127	130	134
Total	1,258	1,355	1,418	1,475	1,546	1,618	1,697
On-budget	923	998	1,043	1,084	1,135	1,187	1,245
Off-budget	335	357	375	392	411	431	452
Outlays							
Discretionary[a]							
Defense	282	270	270	278	285	295	304
International	21	21	22	22	22	23	24
Domestic	243	256	264	274	285	296	307
Unspecified reductions	0	0	-4	-21	-35	-38	-40
Subtotal	546	548	552	553	557	575	595
Mandatory	791	843	897	961	1,025	1,098	1,176
Deposit insurance	-8	-16	-8	-4	-5	-3	-2
Net interest	203	235	260	271	281	296	313
Offsetting receipts	-71	-80	-73	-75	-79	-82	-86
Total	1,461	1,530	1,628	1,706	1,778	1,885	1,997
On-budget	1,182	1,241	1,326	1,393	1,452	1,543	1,641
Off-budget	279	289	302	313	326	342	356
Deficit	203	175	210	230	232	266	299
On-budget deficit	259	243	283	309	317	355	395
Off-budget surplus	56	69	73	79	85	89	96
Debt Held by the Public	3,432	3,618	3,843	4,090	4,338	4,621	4,938
Memorandum:							
Gross Domestic Product	6,632	7,036	7,370	7,747	8,152	8,572	9,013

(Continued)

SOURCE: Congressional Budget Office.

Table A-3.
Continued

	Actual 1994	1995	1996	1997	1998	1999	2000
	As a Percentage of GDP						
Revenues							
Individual income	8.2	8.4	8.5	8.5	8.5	8.5	8.6
Corporate income	2.1	2.1	2.1	2.0	2.0	2.0	1.9
Social insurance	7.0	7.0	7.0	7.0	6.9	6.9	6.9
Other	1.7	1.7	1.7	1.6	1.6	1.5	1.5
Total	19.0	19.3	19.2	19.0	19.0	18.9	18.8
On-budget	13.9	14.2	14.2	14.0	13.9	13.9	13.8
Off-budget	5.1	5.1	5.1	5.1	5.0	5.0	5.0
Outlays							
Discretionary[a]							
Defense	4.3	3.8	3.7	3.6	3.5	3.4	3.4
International	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Domestic	3.7	3.6	3.6	3.5	3.5	3.4	3.4
Unspecified reductions	0	0	-0.1	-0.3	-0.4	-0.4	-0.4
Subtotal	8.2	7.8	7.5	7.1	6.8	6.7	6.6
Mandatory	11.9	12.0	12.2	12.4	12.6	12.8	13.1
Deposit insurance	-0.1	-0.2	-0.1	-0.1	-0.1	b	b
Net interest	3.1	3.3	3.5	3.5	3.4	3.5	3.5
Offsetting receipts	-1.1	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Total	22.0	21.7	22.1	22.0	21.8	22.0	22.2
On-budget	17.8	17.6	18.0	18.0	17.8	18.0	18.2
Off-budget	4.2	4.1	4.1	4.0	4.0	4.0	4.0
Deficit	3.1	2.5	2.9	3.0	2.8	3.1	3.3
On-budget deficit	3.9	3.5	3.8	4.0	3.9	4.1	4.4
Off-budget surplus	0.8	1.0	1.0	1.0	1.0	1.0	1.1
Debt Held by the Public	51.7	51.4	52.1	52.8	53.2	53.9	54.8

a. Projections assume that discretionary spending is equal to the spending limits that are in effect through 1998 and equal to the 1998 limit adjusted for inflation after that. Discretionary outlays would be $19 billion lower in 1999 and $38 billion lower in 2000 if no adjustment for inflation was assumed.

b. Less than 0.05 percent.

actual inflation experienced in the most recently completed year (1994 in this instance) and the inflation anticipated for that year when the limits were set, OMB adjusted for the differences between its current forecast of inflation in 1996, 1997, and 1998 and the inflation forecast for those years when the limits were set. The resulting limits are as much as $9 billion higher by 1998 than CBO estimated in January. Although CBO believes that OMB's interpretation of the law is incorrect, CBO will continue to use OMB's limits in its baseline budget projections.

Other, relatively small revisions to CBO's outlook have occurred since January. Projected Medicaid outlays are expected to grow slightly more slowly than previously assumed, whereas expenditures for Medicare should grow slightly faster. In particular, new data about payments on behalf of Medicare beneficiaries who enroll in health maintenance organizations show those payments rising more rapidly than had been thought earlier. Also, fewer claims are expected in the Federal Housing Administration's mutual mortgage insurance program from properties insured before 1992, thereby generating fewer default payments.

When CBO released its January baseline, the Federal Communications Commission (FCC) had just begun its most recent auction of rights to use portions of the electromagnetic spectrum. Since then, the FCC has received $7 billion in bids in the ongoing auction (in addition to $1 billion from the previous auction). With another $1 billion in receipts expected before the end of the year, CBO has raised its estimate of 1995 auction receipts by $3 billion. CBO has also increased its projection of net spending by deposit insurance agencies by $2 billion in 1996 and $1 billion in 1997 to reflect a further reduction in premiums that banks pay to the Bank Insurance Fund to maintain a balance of $1.25 per $100 of insured deposits.

The remaining tables in this appendix update some of the most widely used information in CBO's January report. Because the revisions are relatively minor, readers seeking a fuller explanation of underlying trends in the budget can rely on that earlier publication.

Much of the concern about the budget stems from the sheer size of the federal deficit; Table A-2 displays several measures of that gap. The most commonly used measure of the deficit is simply the difference between total revenues and spending. As explained above, CBO produces two projections of that difference--one assuming that discretionary spending grows at the rate of inflation after 1998 and the other assuming that it is frozen at the 1998 dollar level.

Participants in the budget debate often cite other measures of the deficit as well--most usefully, the standardized-employment or structural deficit. That figure shows what is left after removing the cyclical deficit--in other words, the weakened revenues and extra benefit spending that result when the economy operates below its potential. With the current economic recovery on a solid footing, the distinction between the structural deficit and the conventionally measured deficit is less relevant now than during periods of slower growth.

Spending and receipts for a number of large programs are generally tracked separately; chief among them are Social Security and the Postal Service (both of which are off-budget under different statutory provisions). The surpluses or deficits of those programs are depicted in Table A-2. Despite their special status, those programs loom so large in the revenue and spending totals that any measure of the budget that omits them yields a distorted picture of the government's drain on credit markets and its role in the economy.

Federal government revenues by source and outlays by broad category, both in dollar terms and in relation to the country's gross domestic product (GDP), are presented in Table A-3. Spending for entitlements and other mandatory programs, by far the largest spending category, will reach almost $850 billion this year and is growing fast. Fueling that growth are expenditures for Social Security, Medicare, and Medicaid, which together account for around three-quarters of all mandatory outlays. Table A-4 displays more information about this huge cluster of programs. In response to increased interest in the projected growth of individual mandatory programs, CBO has for the first time extended that table through 2005.

Table A-4.
CBO's Baseline Projections for Mandatory Spending (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Means-Tested Programs											
Medicaid	89	99	110	122	135	148	163	178	195	212	232
Food Stamps[a]	26	27	29	30	32	33	35	37	38	40	42
Supplemental Security Income	24	24	30	33	36	43	39	47	51	55	64
Family Support	18	19	19	20	20	21	21	22	23	24	24
Veterans' Pensions	3	3	3	3	3	3	3	3	3	3	3
Child Nutrition	8	8	9	9	10	11	11	12	13	13	14
Earned Income Tax Credit	17	20	23	24	25	26	27	28	29	30	31
Student Loans[b]	4	3	3	3	3	3	3	3	4	4	4
Other	3	4	4	5	5	6	6	7	7	8	8
Total, Means-Tested Programs	193	207	229	248	268	293	309	336	362	389	423
Non-Means-Tested Programs											
Social Security	334	352	371	391	412	435	458	483	509	537	566
Medicare	178	199	219	240	263	288	315	345	379	416	458
Subtotal	512	551	590	631	675	723	773	828	888	953	1,024
Other Retirement and Disability											
Federal civilian[c]	42	44	46	49	51	54	57	60	63	66	69
Military	28	28	30	31	33	35	36	38	39	41	43
Other	5	4	4	4	4	5	5	5	5	5	5
Subtotal	74	76	80	84	89	93	98	102	107	112	117
Unemployment Compensation	21	23	24	26	27	28	30	31	33	34	35
Other Programs											
Veterans' benefits[d]	17	17	19	19	20	22	23	24	24	25	26
Social services	6	6	6	6	6	6	6	6	6	6	6
Credit reform liquidating accounts	-1	-4	-6	-7	-7	-7	-7	-7	-7	-7	-7
Other	20	20	19	19	19	18	18	18	18	18	18
Subtotal	42	39	38	36	38	39	40	41	41	42	43
Total, Non-Means-Tested Programs	649	689	732	777	829	883	941	1,002	1,069	1,142	1,220
Total											
Total Mandatory Spending	843	897	961	1,025	1,098	1,176	1,250	1,339	1,431	1,531	1,643

SOURCE: Congressional Budget Office.

NOTE: Spending for major benefit programs shown in this table includes benefits only. Outlays for administrative costs of most benefit programs are classified as domestic discretionary spending; Medicare premium collections are classified as offsetting receipts.

a. Includes nutrition assistance to Puerto Rico.

b. Formerly known as guaranteed student loans.

c. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.

d. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.

In its baseline projections, CBO assumes that policymakers will continue to abide by the discretionary spending limits set in law through 1998. Separate caps apply to both budget authority (the authority to commit funds, the basic currency of the appropriation process) and outlays (actual spending); the stricter constraint governs. The caps have no unique implications for particular programs but rather force a bruising competition for resources. In a reversal from previous years, in 1996 the limit on budget authority may be more constraining than the limit on outlays. Table A-5 shows that preserving resources next year at the 1995 level adjusted for inflation would cause budget authority to exceed the discretionary cap by $13 billion and outlays to exceed the cap by $4 billion. Future cuts are likely to be painful --even a freeze of total discretionary spending at the current level would result in outlays just $12 billion below the caps in 1998.

Net interest payments for the past few years have been remarkably flat (around $200 billion a year), thanks to low interest rates. However, as Table A-6 shows, the combination of higher interest rates and a persistently large deficit will boost net interest to $235 billion in 1995 and over $300 billion in 2000. Correspondingly, federal debt will continue to increase, with debt held by the public rising to almost 55 percent of GDP in 2000.

Long-range budget projections are highly uncertain because no one can foresee the path of the economy or such important trends as growth in health care spending. CBO's long-run extrapolations thus contain less detail than its five-year projections, which are required under the Congressional budget process. Nevertheless, CBO's broad-brush overview suggests that after 1998--in the absence of concerted action by policymakers--the deficit is likely to continue climbing both in dollar terms and, more worrisomely, as a percentage of GDP (see Table A-7). Sustained growth in the two big health care programs, Medicare and Medicaid, is the major reason, as they mount steadily from 3.8 percent of GDP today to 5.9 percent of GDP in 2005.

Most other spending programs, along with federal revenues, are expected to be roughly flat as a percentage of GDP over the next 10 years. Discretionary spending, the exception, will drop sharply (relative to GDP) through 1998. After the caps expire in 1999, the programs governed by them may resume growing, but even if discretionary spending increases at the rate of inflation, it will continue to decline as a proportion of GDP. If discretionary spending is held to the 1998 dollar level, it will decline even more rapidly--to 4.8 percent of GDP by 2005--and the deficit will stabilize at approximately 2.5 percent of GDP (see Table A-8).

Table A-5.
How Tight Are the Discretionary Caps? (By fiscal year, in billions of dollars)

	1996	1997	1998
Budget Authority			
Discretionary Caps[a]	522	535	542
Amount Needed to Preserve 1995 Real Resources			
Defense	272	282	291
International	21	22	23
Domestic	241	251	269
Total	534	555	583
Amount over or under (-) caps	13	20	42
Amount Needed to Freeze 1995 Dollar Resources			
Defense	263	263	263
International	20	20	20
Domestic	227	227	227
Total	511	511	511
Amount over or under (-) caps	-11	-24	-31
Outlays			
Discretionary Caps[a]	552	553	557
Amount Needed to Preserve 1995 Real Resources			
Defense	270	278	285
International	22	22	22
Domestic	264	274	285
Total	556	574	592
Amount over or under (-) caps	4	21	35
Amount Needed to Freeze 1995 Dollar Resources			
Defense	264	264	262
International	21	21	21
Domestic	259	260	262
Total	544	545	545
Amount over or under (-) caps	-8	-9	-12

SOURCE: Congressional Budget Office.

NOTE: Amounts needed to preserve 1995 real resources include adjustments for inflation of about 3 percent a year. Amounts needed to freeze 1995 dollar resources include no adjustments for inflation. Both paths include the budget authority necessary to renew expiring contracts for subsidized housing. There are no discretionary caps after 1998.

a. The caps reflect discretionary spending limits as specified by the Office of Management and Budget in the sequestration preview report included in the President's budget.

Table A-6.
CBO's Baseline Projections for Interest Costs and Federal Debt (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999	2000
Net Interest Outlays (Billions of dollars)							
Interest on Public Debt (Gross interest)[a]	296	340	371	386	401	422	445
Interest Received by Trust Funds							
Social Security	-29	-35	-39	-45	-50	-55	-61
Other trust funds[b]	-56	-62	-63	-63	-63	-63	-62
Subtotal	-86	-96	-102	-107	-112	-118	-123
Other Interest[c]	-8	-8	-8	-8	-7	-8	-8
Total	203	235	260	271	281	296	313
Federal Debt, End of Year (Billions of dollars)							
Gross Federal Debt	4,644	4,943	5,285	5,648	6,013	6,407	6,834
Debt Held by Government Accounts							
Social Security	420	489	561	640	724	812	907
Other government accounts[b]	792	836	881	919	952	973	989
Total	1,212	1,325	1,442	1,559	1,675	1,786	1,896
Debt Held by the Public	3,432	3,618	3,843	4,090	4,338	4,621	4,938
Debt Subject to Limit[d]	4,605	4,903	5,244	5,607	5,971	6,365	6,792
Federal Debt as a Percentage of GDP							
Debt Held by the Public	51.7	51.4	52.1	52.8	53.2	53.9	54.8

SOURCE: Congressional Budget Office.

NOTE: Projections of interest and debt assume compliance with the discretionary spending caps in the Budget Enforcement Act. Discretionary spending is assumed to rise with inflation after the caps expire in 1998.

a. Excludes interest costs of debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).

b. Principally Civil Service Retirement, Military Retirement, Medicare, unemployment insurance, and the Highway and the Airport and Airway trust funds.

c. Primarily interest on loans to the public and to the Resolution Trust Corporation and the Bank Insurance Fund.

d. Differs from the gross federal debt primarily because most debt issued by agencies other than the Treasury is excluded from the debt limit.

Table A-7.
The Budget Outlook Through 2005 with Discretionary Inflation After 1998 (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
In Billions of Dollars											
Revenues	1,355	1,418	1,475	1,546	1,618	1,697	1,787	1,880	1,978	2,082	2,191
Outlays											
Discretionary	548	552	553	557	575	595	615	636	658	680	703
Mandatory	843	897	961	1,025	1,098	1,176	1,250	1,339	1,431	1,531	1,643
Deposit insurance	-16	-8	-4	-5	-3	-2	-2	-2	-2	-1	-1
Net interest	235	260	271	281	296	313	329	350	372	397	424
Offsetting receipts	-80	-73	-75	-79	-82	-86	-90	-94	-98	-102	-107
Total	1,530	1,628	1,706	1,778	1,885	1,997	2,103	2,229	2,361	2,504	2,663
Deficit	175	210	230	232	266	299	316	349	384	422	472
Social Security Surplus	69	73	78	84	89	95	102	109	116	124	133
Hospital Insurance Surplus	3	-2	-9	-15	-22	-29	-37	-46	-56	-67	-80
Debt Held by the Public	3,618	3,843	4,090	4,338	4,621	4,938	5,271	5,638	6,040	6,479	6,969
As a Percentage of GDP											
Revenues	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays											
Discretionary	7.8	7.5	7.1	6.8	6.7	6.6	6.5	6.4	6.3	6.2	6.1
Mandatory	12.0	12.2	12.4	12.6	12.8	13.1	13.2	13.4	13.6	13.9	14.1
Deposit insurance	-0.2	-0.1	-0.1	-0.1	a	a	a	a	a	a	a
Net interest	3.3	3.5	3.5	3.4	3.5	3.5	3.5	3.5	3.5	3.6	3.6
Offsetting receipts	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9
Total	21.7	22.1	22.0	21.8	22.0	22.2	22.2	22.3	22.5	22.7	22.9
Deficit	2.5	2.9	3.0	2.8	3.1	3.3	3.3	3.5	3.7	3.8	4.1
Social Security Surplus	1.0	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Hospital Insurance Surplus	a	a	-0.1	-0.2	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6	-0.7
Debt Held by the Public	51.4	52.1	52.8	53.2	53.9	54.8	55.6	56.5	57.5	58.7	60.0

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent of GDP.

Table A-8.
The Budget Outlook Through 2005 Without Discretionary Inflation After 1998 (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
In Billions of Dollars											
Revenues	1,355	1,418	1,475	1,546	1,618	1,697	1,787	1,880	1,978	2,082	2,191
Outlays											
Discretionary	548	552	553	557	557	557	557	557	557	557	557
Net interest	235	260	271	281	295	311	324	339	355	372	389
All other[a]	747	816	881	941	1,013	1,088	1,158	1,243	1,331	1,427	1,535
Total	1,530	1,628	1,706	1,778	1,865	1,956	2,038	2,139	2,243	2,355	2,481
Deficit	175	210	230	232	247	258	252	259	266	273	290
Debt Held by the Public	3,618	3,843	4,090	4,338	4,602	4,877	5,146	5,423	5,707	5,998	6,306
As a Percentage of GDP											
Revenues	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays											
Discretionary	7.8	7.5	7.1	6.8	6.5	6.2	5.9	5.6	5.3	5.0	4.8
Net interest	3.3	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.3
All other[a]	10.6	11.1	11.4	11.5	11.8	12.1	12.2	12.5	12.7	12.9	13.2
Total	21.7	22.1	22.0	21.8	21.8	21.7	21.5	21.4	21.4	21.3	21.3
Deficit	2.5	2.9	3.0	2.8	2.9	2.9	2.7	2.6	2.5	2.5	2.5
Debt Held by the Public	51.4	52.1	52.8	53.2	53.7	54.1	54.3	54.4	54.4	54.3	54.2

SOURCE: Congressional Budget Office.

a. Spending for all other categories--mandatory outlays, deposit insurance, and offsetting receipts--would be the same as in Table A-7.

Appendix B

Economic and Budgetary Implications of Balancing the Budget

The Congressional Budget Office's (CBO's) January report, *The Economic and Budget Outlook: Fiscal Years 1996-2000*, laid out one of many possible paths of deficit reduction that would lead to a balanced budget by 2002. CBO has updated that illustrative path to reflect the revisions to the baseline projections of the budget in this report (see Table B-1). The January report also briefly discussed the possibility that reducing the budget deficit would positively affect the overall economy, which in turn would yield further reductions in the deficit. This appendix expands on that discussion and provides estimates of those impacts.

Balancing the budget over the next seven years will require many hard decisions about taxing and spending policies, and many of those choices will have important implications for the nation's economic outlook. Although the details of those decisions have yet to be worked out, some likely macroeconomic effects that flow simply from balancing the budget can be anticipated, based on available empirical research. CBO's analysis indicates that growth is likely to be modestly higher, on average, from now until 2002, provided that the policy changes necessary to balance the budget do not fall especially hard on private saving or on productive public investments (see Tables B-2 and B-3). Inflation could increase or decrease slightly but should not be much affected. In the short term, although some bumps could appear in the road, the fiscal restraint implied by the effort to balance the budget need not weaken the economy substantially as long as the Federal Reserve acts to offset that restraint. Interest rates are likely to be significantly lower, falling to the range that they inhabited in the 1950s and 1960s, when budget deficits were typically modest by today's standards.

Most of the benefits of balancing the budget would accrue over time, becoming more pronounced after the next seven years. Thus, the major beneficiaries of a balanced budget may be future generations, who would gain from both the nation's increased productive capacity and a lower burden of debt. Indeed, current fiscal policies literally cannot remain unchanged indefinitely: at some time, action will have to be taken to bring government borrowing under control, or servicing the federal debt will require unsustainable tax rates in future years. Prompt action would limit the damage that occurs when federal debt crowds out capital investment, putting upward pressures on interest rates. It would also limit the size of the needed changes in fiscal policy.

The estimates in this appendix of the economic implications of balancing the budget over the next seven years reflect only the macroeconomic component of effects on national saving and investment in an environment with a favorable monetary policy. The actual outcomes will depend on the fiscal and monetary policy choices that are made. If the deficit is closed by means that lead to particularly strong disincentives for private saving or investment, or by reducing productive government investments, the benefits of eliminating the deficit could be reduced. Moreover, monetary policy that does not accommodate the fiscal restraint inherent in a balanced budget

could lead to short-run losses in output--and in incomes as well. Of course, policy changes could also work the other way--by increasing private and public investment. In that case, the nation's economic outlook under a balanced budget would be enhanced. Because those policy decisions have not been made, their effects are not included in this analysis.

An Illustrative Path to a Balanced Budget

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002

Table B-1.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO March Baseline Deficit with Discretionary Inflation After 1998[a]	175	210	230	232	266	299	316	349	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-59	-80	-196
Debt service	0	0	0	0	-1	-3	-6	-10	-19
Deficit Reduction	0	0	0	0	-20	-41	-64	-90	-215
CBO March Baseline Deficit Without Discretionary Inflation After 1998[b]	175	210	230	232	247	258	252	259	n.a.
Additional Deficit Reduction									
Policy changes[c]	0	-36	-72	-107	-161	-173	-186	-200	-934
Debt service	0	-1	-5	-11	-20	-32	-45	-60	-173
Deficit Reduction	0	-37	-76	-118	-181	-204	-231	-259	-1,107
Resulting Deficit	175	173	154	114	66	54	21	d	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-36	-72	-107	-180	-211	-245	-279	-1,130
Debt service	0	-1	-5	-11	-21	-34	-50	-70	-192
Total Deficit Reduction	0	-37	-76	-118	-200	-245	-295	-349	-1,322

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Assumes compliance with discretionary spending limits of the Balanced Budget and Emergency Deficit Control Act through 1998. Discretionary spending is assumed to increase at the rate of inflation after 1998.

b. Assumes compliance with discretionary spending limits of the Balanced Budget and Emergency Deficit Control Act through 1998. Discretionary spending is frozen at the 1998 level after that year.

c. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. This path is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

d. Surplus of less than $500 million.

(see Table B-1). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. The freeze, along with the resulting debt-service effects, would produce $90 billion of the required savings of $349 billion in 2002. Such a freeze would reduce the buying power of total discretionary appropriations nearly 20 percent below the 1995 level.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on any particular set of policies. The pattern of savings between 1996 and 1999, however, is similar to the phasing in of changes in mandatory spending enacted in the last two major efforts at reducing the deficit, in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security--implying that the cuts made in earlier years are permanent but no additional policy changes are made. If those savings were achieved entirely out of entitlement or other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

Over the entire period from 1996 to 2002, the policy changes in CBO's illustrative path would save more than $1.1 trillion from a baseline that adjusts discretionary spending for inflation after 1998. The cost of servicing the public debt would also fall, and when that cost is included, the total savings exceed $1.3 trillion. This path and the resulting savings are no more than illustrative: the cumulative amount of deficit reduction between 1996 and 2002 will depend on the timing and nature of the policy changes chosen to achieve balance in 2002.

Many of the estimates in this appendix of the economic effects of balancing the budget are based on model simulations, which required additional assumptions about the nature of the policies chosen to balance the budget. Those simulations assumed that the budget would be balanced smoothly over the next

Table B-2.
Potential Economic Impacts of Balancing the Budget by 2002 Compared with CBO's January Economic Forecast (By calendar year)

	1996	1997	1998	1999	2000	2001	2002
Interest Rates (Percentage points)							
Three-month Treasury bills	-0.2	-0.4	-0.7	-0.9	-1.1	-1.1	-1.1
Ten-year Treasury notes	-0.2	-0.5	-0.8	-1.1	-1.4	-1.7	-1.7
Real Gross National Product							
Percentage change in level from base	0.1	0.2	0.3	0.4	0.6	0.7	0.8
Change in growth rate (Percentage points)	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Real Gross Domestic Product							
Percentage change in level from base	0	0.1	0.2	0.3	0.3	0.4	0.5
Change in growth rate (Percentage points)	0	0.1	0.1	0.1	0.1	0.1	0.1

SOURCE: Congressional Budget Office.

Table B-3.
CBO's January Economic Forecast After Adjusting for the Economic Impacts of Balancing the Budget (By calendar year, in percent)

	1996	1997	1998	1999	2000	2001	2002
Nominal GDP Growth	4.7	5.3	5.3	5.2	5.2	5.3	5.3
Real GDP Growth	1.8	2.5	2.4	2.4	2.4	2.4	2.4
Inflation (CPI-U)	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Unemployment	5.7	5.8	5.9	6.0	6.0	6.0	6.0
Interest Rates							
Three-month Treasury bills	5.5	4.9	4.5	4.2	4.0	4.0	4.0
Ten-year Treasury notes	6.8	6.2	5.9	5.6	5.3	5.1	5.1

SOURCE: Congressional Budget Office.

NOTE: CPI-U = consumer price index for urban consumers.

seven years, following the illustrative path laid out above. Moreover, they assumed that the policy actions would be on the outlay side of the budget rather than on the revenue side. The broad conclusions apply, however, to many other ways of reaching balance, provided that those methods do not involve changes in marginal rates of taxation on saving, on the return from capital, or on labor. Finally, the simulations assumed that both financial markets and the Federal Reserve would view the policy changes as a credible route to balancing the budget.

Increased Growth

Balancing the budget by 2002 could allow the economy to grow modestly faster--by about 0.1 percentage point per year on average. By 2002, the annual level of gross national product (GNP) might be about 0.8 percent higher than it would be if fiscal policy continued on its current path.[1] Moving to a balanced budget would add to growth by redirecting resources away from public and private consumption and toward investment and an improved national balance sheet--especially by cutting the current pace of borrowing from foreigners and eliminating the need to service that debt.

In balancing the budget, private saving is likely to decrease, although to what extent is highly uncertain. How much private saving drops off will depend critically on how the deficit is reduced and whether policy changes alter any of the tax factors that enter into decisions to save. Without such changes in taxes, private saving might fall by between 20 percent and 40 percent of the reduction in the deficit, according to the models that CBO has analyzed. Thus, national wealth would increase by between 60 percent and 80 percent of the cumulative reduction in the deficit.

Some of the rise in national wealth would appear as a higher level of capital stock (increasing productive capacity in the United States), and some would show up as lower levels of borrowing from foreigners. No consensus exists on how much each of those elements would change, but the range of possible increases in productive capacity over the next seven years is limited. The existing capital stock is large; it takes years to change by a noticeable proportion. Moreover, the models that CBO has examined predict an increase in private investment of only about 20 percent of the amount of reduction in the deficit. Such an increase would raise the capital stock by

1. The more familiar concept of gross domestic product (GDP) measures only production in the United States and does not reflect the decline in debt service to foreigners. Thus, GNP could increase by some 0.8 percent in 2002, but GDP might increase by only 0.5 percent.

about 2.2 percent in 2002, expanding productive capacity by about 0.5 percent.

The shift of resources to investment and net exports may not go smoothly, however. Balancing the budget implies a substantial amount of restraint overall, averaging some 0.4 percent of GDP each year for seven years. (Usually, fiscal restraint lasts for two years or less.) If the Federal Reserve failed to offset restraint, consumption could fall more quickly than investment and net exports rise, with the result that the economy could weaken in the short run. The Federal Reserve might welcome fiscal restraint if the economy seemed close to overheating, for example. Moreover, even if the Federal Reserve sought to offset fiscal restraint with a more expansionary monetary policy, the effects of monetary policy on the economy are uncertain, both in their size and timing. Because a perfect offset would be too much to expect, budget balancing risks some temporary reduction in real GDP.

Nevertheless, the danger of a substantial downturn seems small, provided that changes in spending and taxes follow a relatively smooth path and are credible to both financial markets and the Federal Reserve. Given such credibility, long-term interest rates are likely to fall and help boost domestic investment, and the Federal Reserve could act early to reduce short-term rates. The annual amount of restraint, moreover, does not seem unmanageable, provided that the deficit is reduced reasonably smoothly. Although some bumps could occur along the way, those short-term problems should not interfere with the investment and gains in productivity that would bring increased growth between now and 2002.

The Federal Reserve's actions could also affect the rate of inflation. On the one hand, inflation could rise temporarily because lower interest rates in the United States would reduce the value of the dollar and raise the price of imports. On the other hand, if the Federal Reserve targeted nominal GDP, inflation could eventually fall by as much as the growth in real GDP. In short, the net effect on inflation cannot be predicted with any confidence.

Lower Interest Rates

Economists disagree widely over the effect of fiscal policy on interest rates. Some believe that the openness of U.S. capital markets ensures that real rates cannot stray far from those in other countries, and thus they would give little credence to any fiscally induced change in real rates. Others, using models of the U.S. economy alone, cite much larger impacts: according to one of those models, balancing the budget could reduce long-term interest rates by as much as 400 basis points.

Good arguments exist for a more reasonable range that encompasses the uncertainty about the likely effects of balancing the budget--a range of from 100 to 200 basis points. A drop of that magnitude from CBO's baseline forecast would leave real long-term rates at between 1 percent and 2 percent--lower than they have been since the 1950s--and real short-term rates close to zero. During the 1970s, short-term rates fell below the rate of inflation largely because of unanticipated increases in inflation and inappropriately expansionary monetary policy. But in periods without such policy mistakes, real short-term interest rates have rarely been as low as zero.

How quickly rates would fall depends on many poorly understood factors, but the drop in rates would probably anticipate any actual reduction in the deficit by a year or so. Long-term interest rates, for example, might respond to announced future reductions in the deficit if those reductions seemed credible--and as the Congress proceeds along the path of deficit reduction, credibility is likely to increase. The timing of a fall in short-term rates would depend on when the Federal Reserve acted, which--given the long lags in the effect of monetary policy on the economy--could also anticipate the actual decline in the deficit. CBO has assumed, relatively conservatively, that the reduction in both long- and short-term rates might occur over a five- to six-year period. Some analysts might argue that long-term rates could respond even faster, as for instance they did after en-

actment of the Omnibus Budget Reconciliation Act of 1993. But the evidence on the cause of that drop is mixed: the sharp decline in long-term rates in 1993 could also be attributed to falling expectations about inflation--and in any case the decline was partly reversed within a year. Moreover, long-term rates did not fall quickly following enactment of a similar fiscal package in 1990. With such conflicting evidence, some caution about the likely speed of reductions in interest rates seems warranted.

Very Large Reductions in Rates Seem Unlikely

One widely used model, developed by Data Resources Inc. (DRI), predicts an exceptionally large drop in interest rates as the deficit falls--nearly 400 basis points in the simulations carried out by CBO. (When DRI carries out similar simulations, it uses different auxiliary assumptions and arrives at somewhat smaller impacts on rates. The drop in interest rates is still, however, much larger than that derived from other models.) In the DRI model, domestic saving and investment respond much more slowly to changes in interest rates than is the case in the other models CBO examined. Consequently, interest rates must fall substantially in order for investment to replace the public and private consumption lost to fiscal restraint.

Such large reductions in rates lack credibility from another point of view: when combined with CBO's base forecast of interest rates, they would push real rates well below those that prevailed in the 1950s and 1960s, when the deficit was generally expected to remain under control. Indeed, the DRI results imply that negative real interest rates would persist for years.

A Lack of Effect on Interest Rates Also Seems Unlikely

Those who expect deficit reduction to have little or no impact on interest rates probably overstate their case as well. Their argument is that because the U.S. capital market is wide open to lending to and borrowing from foreigners, interest rates in the United States cannot long deviate from world rates. As a result, real interest rates cannot respond to changes in the U.S. budget deficit.

The United States, however, is a big enough player that changes in its markets can affect world capital markets. In the early 1980s, for example, the rise of government borrowing in the United States, together with tight monetary policy at the beginning of the decade, was blamed for increases in world interest rates. Those high rates precipitated a crisis for developing countries like Mexico that had borrowed too freely in the 1970s.

U.S. interest rates can, moreover, deviate persistently from foreign rates, provided that the expected returns to foreigners investing in the United States remain similar to those that foreigners would receive for investing in their own economies. The return for foreigners investing in the United States comprises two elements: the interest paid (in dollars) on U.S. liabilities, and the expected capital gains or losses (in German marks or Japanese yen) that occur as exchange rates shift. Changes in the expected movements of currency values allow fiscal excess to raise interest rates in the United States above those in foreign economies--as occurred in the early 1980s. Correspondingly, fiscal restraint will reduce U.S. interest rates by more than the reductions occurring in other countries that do not undergo the same contraction. (Initially, fiscal restraint and lower interest rates in the United States will lead to a drop in the value of the dollar relative to other currencies, but subsequently the dollar will begin to appreciate.)

CBO has examined one model that incorporates the two elements noted above. The MSG model simulates how foreign interest rates would fall and how exchange rate movements would permit changes in the differential between U.S. and foreign rates.[2] The model predicts a decline of 160 basis points in interest rates by 2002 under a balanced budget.

Interest rates may also differ among nations because the liabilities of different countries do not appear exactly the same to investors. Although capital

2. See Warwick McKibbin and Jeffrey Sachs, *Global Linkages: Macroeconomic Interdependence and Cooperation in the World Economy* (Washington, D.C.: Brookings Institution, May 1991).

Table B-4.
Change in the Federal Deficit Resulting from the Economic Impacts of Balancing the Budget by 2002 (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002
Change Resulting from Lower Interest Rates							
Outlays (Net interest)	-2	-6	-12	-20	-28	-36	-42
Revenues (Federal Reserve earnings)[a]	b	1	2	3	4	5	5
Subtotal	-2	-5	-10	-17	-24	-31	-37
Change Resulting from Higher GDP (Revenues)	-1	-2	-4	-6	-8	-10	-13
Total Effect on Deficit	-3	-7	-14	-23	-32	-41	-50

SOURCE: Congressional Budget Office.

NOTE: These estimates assume that the budget is balanced by 2002. Outstanding debt depends only on the budget deficit and is unaffected by the changes reflected in this table. Consequently, no further savings in servicing the debt accrue from these changes.

a. Revenue reductions are shown as positive because they increase the deficit.

b. Less than $500 million.

markets are well integrated, they are not perfectly meshed, and in some, the opportunities for hedging are limited. Moreover, if the United States was to continue on its current fiscal track, the risk of holding dollar securities could rise.

CBO's Estimate

Although the extremes of the range of impacts on interest rates can be ignored, narrowing the range any further than to between 100 and 200 basis points proves difficult. CBO's estimates, shown in Table B-2, split that range, since they imply that a weighted average of interest rates would drop by 150 basis points over six years. (The weights are 25 percent on short-term rates and 75 percent on long-term rates and roughly reflect the shares of short- and long-term securities in current federal borrowing from the public.) Long-term rates drop more than short-term ones, on the assumption that the policies undertaken to balance the budget will put the long-term fiscal outlook on a more sustainable path than is possible under current policies.

The Uncertainty of the Economic Estimates

The estimates in Tables B-2 and B-3 are subject to two kinds of uncertainty. The first, which has been discussed at length, is the substantial uncertainty about the effects of balancing the budget, assuming that other outcomes match CBO's January expectations. The second kind of uncertainty arises because many things will happen--not just in the area of fiscal policy but in the rest of the economy--that CBO could not anticipate in its January forecast. For example, the forecast did not anticipate that growth in GDP for the fourth quarter of 1994 would be revised upward to 5.2 percent; neither did it anticipate the weakness of the dollar against the yen.

Such events beyond the domain of fiscal policy could easily obscure the impacts on growth and interest rates that balancing the budget would set in motion. For example, if the weakness of the dollar continues, the Federal Reserve might be unwilling to

lower interest rates as quickly as the budget-balancing scenario assumes. The estimates in Tables B-2 and B-3 should therefore be viewed with appropriate caution: a few years down the road, it may be impossible to disentangle the effects of balancing the budget from other forces operating at the same time in the U.S. economy.

Budgetary Effects

Budgetary savings would result from both the reduction in interest rates and the increase in real GDP and GNP (see Table B-4). Lower interest rates would cut the cost of federal payments for interest on the debt held by the public. A portion of those interest payments goes to the Federal Reserve, which holds significant amounts of government securities. Because the Federal Reserve returns its earnings to the federal government, the smaller interest payment to the Federal Reserve (which is reflected in the estimate of the effect of lower interest rates on net interest payments) is offset by a smaller amount of earnings returned to the government. The offset is shown separately because the collections from the Federal Reserve are recorded in the budget as revenues, rather than as offsets to net interest outlays. The increase in economic activity reflected in the faster growth of GDP would generate additional revenues from income and payroll taxes and from customs duties. The estimated increase in revenues also reflects a rise in tax revenues on interest income. That rise occurs because a smaller proportion of such income would be paid to foreigners to service accumulated debt.

Appendix C

Major Contributors to the Revenue and Spending Projections

The following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

Revenue Projections

Mark Booth	Corporate income taxes, Federal Reserve System earnings, excise taxes
Drew McMorrow	Excise taxes
Peter Ricoy	Social insurance contributions, estate and gift taxes
Melissa Sampson	Customs duties, miscellaneous receipts
David Weiner	Individual income taxes

Spending Projections

Defense, International Affairs, and Veterans' Affairs

Elizabeth Chambers	Military retirement, atomic energy, defense, military health care
Kent Christensen	Defense
Christopher Duncan	International affairs
Victoria Fraider	Veterans' education and housing, defense (weapons)
Michael Groarke	Veterans' housing and medical care
Raymond Hall	Defense (weapons)
William Myers	Defense (weapons)
Mary Helen Petrus	Veterans' compensation, pensions, and medical care
Amy Plapp	Defense (personnel)
Joseph Whitehill	International affairs

Human Resources

Wayne Boyington	Civil Service Retirement, Social Security, Pension Benefit Guarantee Corporation
Scott Harrison	Medicare
Christie Hawley	Unemployment insurance, training programs
Jean Hearne	Medicaid
Lori Housman	Medicare
Deborah Kalcevic	Education
Lisa Layman	Medicare
Jeffrey Lemieux	Federal employee health benefits, national health expenditures
Dorothy Rosenbaum	Social services, food stamps, child nutrition
Robin Rudowitz	Medicaid
Kathy Ruffing	Supplemental Security Income, Social Security
Connie Takata	Public Health Service
John Tapogna	Aid to Families with Dependent Children, child support enforcement

Natural and Physical Resources

Kim Cawley	Energy, pollution control and abatement
Peter Fontaine	Energy, Outer Continental Shelf receipts
Mark Grabowicz	Science and space, justice, general government
Theresa Gullo	Conservation, land management
David Hull	Agriculture
Mary Maginniss	Deposit insurance, Postal Service, legislative branch
Eileen Manfredi	Agriculture
Ian McCormick	Agriculture, water resources
Susanne Mehlman	Justice, Federal Housing Administration, general government
David Moore	Spectrum auction receipts
John Patterson	Transportation
Deborah Reis	Recreation, water transportation
Rachel Robertson	Community and regional development, natural resources
Judith Ruud	Deposit insurance
Brent Shipp	Housing and mortgage credit
John Webb	Commerce, disaster relief

Other

Janet Airis	Appropriation bills
Edward Blau	Authorization bills
Jodi Capps	Appropriation bills
Karin Carr	Budget projections, historical budget data, other interest
Betty Embrey	Appropriation bills
Kenneth Farris	Computer support
Vernon Hammett	Computer support
Ellen Hays	Credit programs
Sandra Hoffman	Computer support
Jeffrey Holland	Net interest on the public debt, national income and product accounts

Deborah Keefe	Computer support
Daniel Kowalski	Credit programs
Catherine Mallison	Appropriation bills
Robert Sempsey	Appropriation bills
Susan Strandberg	Budget projections, civilian agency pay